

Data Collection Survey on Investment Climate in Sri Lanka Final Report

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EY Advisory & Consulting Co., Ltd.

Ernst & Young ShinNihon LLC

Ernst & Young Sustainability Co., Ltd.

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Data Collection Survey on Investment Climate in Sri Lanka Executive Summary

1 Outline of Survey

The aim of this survey is to collect information on the investment climate of Sri Lanka through the examination of the country's business environment, the structure of FDI promotion, and the interests of foreign investors, based on which Action Plan is proposed.

Interviews were conducted with major government organizations such as the Ministry of Strategic Development and International Trade (MODSIT), the Board of Investment (BOI) and the Export Development Board (EDB). In addition, investors were interviewed to understand the merits and issues of the investment climate in Sri Lanka, as well as to collect case examples where investment was or given up.

Based on these interviews and document analysis, an Action Plan for the Government of Sri Lanka (GOSL) was developed and proposed at a seminar held in Colombo, where feedback on the survey results were retrieved from GOSL officials and private sectors participants.

2 Overview of Sri Lanka

2.1 Macro-economy of Sri Lanka

Sri Lanka has recorded a real GDP growth of 8 to 9% annually from 2009 to 2012, and has continued its growth with an annual rate of 4 to 5% for the past three years. In 2015, the nominal GDP had successfully doubled since 2008 reaching USD 81 billion, and the per capita GDP reached USD 3,850 in the same year. On the other hand, the continuing fiscal deficit has raised the debt-to-GDP ratio to 76% in 2015, which is higher than neighbouring countries such as India (69.6%) and Bangladesh (33.9%). The government needs to take actions for smooth debt redemption by improving revenues through tax increase, stabilizing currency value through tighter expense control, and developing export-oriented industries to generate foreign currency earning opportunities.

2.2 Status of FDI in Sri Lanka

FDI to Sri Lanka tend to focus on specific sectors, such as infrastructure and services, while investment to manufacturing industries has remained low. The total amount of FDI to Sri Lanka approved by BOI in 2015 was USD 969.7 million, which was a 36.6% decline from 2014. This was due particularly to the decline in the service sector (-49.6%) and the infrastructure sector (-33.6%). Investment in the agricultural product processing industry and textile & apparel industry, both traditionally strong industries of Sri Lanka, also showed a decline in the same period, and these tendencies call for urgent needs of transforming to a more high value added and export-oriented industry structure.

3 Business Investment Climate and Issues

3.1 Government Organizations

BOI, the government organization responsible for FDI promotion in Sri Lanka, provides information for investors through seminars and its website. BOI also assists investors in obtaining necessary approvals for

investment, as well as manage the twelve Export Processing Zones (EPZs) in the country. However, BOI's services to encourage existing investors to expand their businesses or re-investment are relatively weak. Granting tax exemptions was one of BOI's main roles until the responsibility moved to the Ministry of Finance (MOF) in 2011.

3.2 Regulations on Investment

The Exchange Control Act (ECA) defines business types that foreign investment is prohibited. Revision of the ECA is under discussion as of August 2017. Additionally, amendments to the Inland Revenue Act (IRA) was submitted to the parliament early July 2017, where it is said that tax exemptions to FDI project will not be granted anymore in principle.

3.3 Issues of Investment Promotion

The World Bank's *Doing Business 2017* ranked Sri Lanka 110 among 190 countries. The government of Sri Lanka stated in its *Public Investment Programme 2017-2020* (PIP) that the country will aim to be ranked at 70 by year 2020. Assessment by *Doing Business 2017* shows that Sri Lanka scored below regional average in several criteria such as "Getting Credit", "Paying Tax" and "Enforcing Contracts". Lack of transparency and consistency of the country's legislative system are highlighted in Sri Lanka's business environment, which have also been pointed out by several private investors. Specifically, lack of transparency comes from difficulties in understanding non-effectiveness of regulations, due to insufficient dissemination when regulations change. The high frequency of regulatory changes is also an issue, causing inconsistency and unpredictability in businesses.

For instance, the authority to grant tax exemptions was removed from the BOI to MOF in 2011, but the corresponding BOI Regulation No. 2, 2006 is still posted on its official website, creating confusion among investors. Also, frequent and sudden changes create room for different interpretations by different practitioners and enforcers, damaging transparency of business environment.

3.4 Article 16 & 17 Companies of BOI Act and Minimum Investment Criteria

BOI Regulation No.2, 2006 is the guideline for Section 17 of the BOI Act, and it defines the regulations related to the granting of preferential treatments, such as tax exemptions, depending on investment amount that needs to be USD 250,000 or above. With the revision of the IRA in 2011, granting tax exemption base on BOI Act is now invalid, but the regulation is still being referred by BOI officials as a guideline for applying other services than originally-intended tax exemption. Moreover, the regulation remains posted on the BOI's website. This, as a result, is creating confusion among potential investors with regard to the validity and enforceability of minimum investment criteria.

3.5 Investment Promotion Agency

BOI was regarded as a tax exemption granting organization until 2011, when MOF took over the roles of tax exemption assessment for investors. Following the global trend of FDI promotion, BOI should pay more attention to promoting investors entering the country, and support faster acquisition of necessary

licenses. Additionally, more efforts should be made to prepare a better business environment for existing investors who wish to expand their operations or to make re-investments.

3.6 Infrastructure

(1) Overall Infrastructure

The quality of public utility infrastructure in Sri Lanka, excluding railways, is said to be almost equal to those in India, and relatively better than those in Pakistan and Bangladesh overall.

(2) EPZs & IP

BOI is operating twelve EPZs and Industrial Parks (IP) in Sri Lanka, of which 94% is occupied, leaving only a limited space available for new entrants and expansion. Until a new EPZ is developed, an introduction of rental factories and legitimation of consignment production outside of EPZs is recommended.

4 Sri Lanka's Business Environment from Investors' Perspective

Although eight years have passed since the end of the civil war, some foreign investors still perceive Sri Lanka as a nation under confusion. Additionally, the country's relatively small population is giving an impression that the market size and labour force are small. On the other hand, the quality of Sri Lankan labour, especially the capacity and speed of learning new skills, is highly valued by investors.

4.1 Skilled Labour Development

Investors highly admire the diligence and learning speed of Sri Lankan workers. One of the common strategic features found among active investors in Sri Lanka was the utilization of highly skilled Sri Lankan workers to fabricate high-end products to be exported to Europe and the US. However, securing trained and skilled labour force is an issue for investors. German Tech (Ceylon German Technical Training Institute) is one of the renowned public technical institutions in Sri Lanka, receiving five times more applications than admission opening yearly. However, half of the highly competitive graduates from the institution go abroad to find jobs.

Investors have also pointed out that the skills taught in high education do not necessarily match the skills in demand.

4.2 Identifying Prioritized Industries

Several similar studies have been conducted in Sri Lanka with support from development partners since 2016 for identifying prospective industries for promotion and they recommended approximately ten industries. Based on those studies, the survey team further narrowed them down to a few prioritized industries. First, industries that are already large and on track to be developed, such as apparel, ICT, logistics, and tourism, were excluded. On the other hand, industries that are currently small but with high potential for exporting were closely examined. Automobile parts and electronics/electrics manufacturing were evaluated lower priority in other studies. However, the survey team confirmed through discussion with other

development partners that such result was due to lack of human resources in these industries, and that these industries could become high potential industries once sufficient skilled labour is steadily supplied.

Since automobile parts and electronics/electrics manufacturing in Sri Lanka are currently small in scale but have multiple successful investment examples, and because these industries have the potential to create more job opportunities and to increase exports, these two industries are recommended for prioritized industries.

5 Action Plan for Improving of Investment Climate in Sri Lanka

5.1 Action Plan

Action Plan is proposed for improving Sri Lanka's investment climate. Actions are categorized into three key areas, namely "Business Environment", "Business Infrastructure" and "Industry Development," and proposed to be carried out in a certain time frame.

(1) Business Environment

Sri Lanka's regulatory framework needs to reinforce its transparency and consistency as depicted in the *Doing Business* by the World Bank. Timely announcements of regulatory changes are indispensable to build a more predictable business environment.

The legal validity of the minimum investment criteria in BOI Regulation No.2, 2006 needs to be clarified and posted appropriately on the BOI's web site to avoid creating misunderstandings among investors. Information dissemination of regulatory changes that impact the business activity, such as information on tax administration, should be imposed a certain mandatory notice period to minimize confusion.

Along with clarification of the minimum investment criteria, BOI should enhance its function of inviting new investments as well as of encouraging re-investments from existing investors.

(2) Business Infrastructure

To deal with the shortage of land in EPZs, and as interim measures until a new EPZ is developed, 1) legitimization of consignment production, and 2) establishment of rental factories, are recommended. Consignment production is to outsource part of the manufacturing process outside of EPZ and to bring fabricated goods-in-process back to the EPZ for export. The process has already been adopted by several investors exceptionally, enabling the expansion of business, generation of job opportunities in rural areas, and active engagement of female work forces.

A rental factory is a sub-let facility at small scales enabling small-medium scale investment within or outside EPZ, where utilities (electricity infrastructure, water infrastructure, etc.) are already furnished. In South East Asia, rental factories have provided opportunities for automobile parts and electronics/electric manufacturers that are small-medium scale but have outstanding technique. To enable these measures in EPZs, BOI should cooperate with the private sector and seek their knowledge.

Also, to enable workers with high learning skills to join the exporting industry, private companies should engage with vocational training institutions to develop curriculums and to provide job

opportunities after the training.

(3) Industry Development

As mentioned above, similar studies were conducted since 2016 to identify prospective industries in Sri Lanka suggesting around ten industries. Because it is unrealistic to promote all of the ten at one time, the government of Sri Lanka should further narrow them down to a few prioritized industries. Two selection criteria are proposed: (1) an existence of successful pioneer companies in Sri Lanka, and (2) the potential of fostering supporting industries to boost job opportunities and export. Industry development master plans should be prepared for each of prioritized industries, and at the same time, promotion activities of Sri Lanka as an investment destination should be organized jointly by public and private sectors.

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Abbreviations

| Acronym | Definition |
|---------|--|
| APTA | Asia Pacific Trade Agreement |
| ASEAN | Association of South-East Asian Nations |
| BIA | Bandaranaike International Airport |
| BIMSTEC | Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation |
| BOI | Board of Investment |
| BPM | Business Process Management |
| BPO | Business Process Outsourcing |
| CCC | Ceylon Chamber of Commerce |
| CEB | Ceylon Electricity Board |
| CIAC | Colombo International Arbitration Centre |
| CoC | Certificate of Conformity |
| DB | Doing Business |
| DPL | Development Policy Loan |
| DTA | Double Tax Avoidance Treaty |
| DTAA | Double Taxation Avoidance Agreement |
| DWDM | Dense Wavelength Division Multiplexing |
| EDB | Export Development Board |
| EFCA | Exporters Foreign Currency Account |
| EFF | Extended Fund Facility |
| EPZ | Export Processing Zone |
| ESC | Economic Service Charge |
| FCBU | Foreign Currency Banking Unit |
| FDI | Foreign Direct Investment |
| FEEA | Foreign Exchange Earners Accounts |
| FTA | Free Trade Agreement |
| FTZ | Free Trade Zone |
| GCEC | The Greater Colombo Economic Development Commission |
| GSP | General Scheme of Preference |
| GST | Goods and Services Tax |
| GSTP | The Global System of Trade Preference |
| HACCP | Hazard Analysis and Critical Control Point |
| HIDA | The Overseas Human Resources and Industry Development Association |
| IAFC | Investment Appraisal Facilitation Committee |
| ICT | Information and Communication Technology |
| IDG | International Development Group |
| IFC | International Finance Corporation of the World Bank Group |

| Acronym | Definition |
|----------|---|
| IIA | Inward Investment Account |
| ILCP | Institute for the Development of Commercial Law and Practices |
| IMF | International Monetary Fund |
| IP | Industrial Park |
| IPA | Investment Protection Agreements |
| IRA | Inland Revenue Act |
| IRD | Inland Revenue Department |
| ISFTA | Indo-Sri Lanka Free Trade Agreement |
| JAAFSL | Joint Apparel Association Forum Sri Lanka |
| JASTECA | Japan Sri Lanka Technical & Cultural Association |
| KPI | Key Performance Indicator |
| KPO | Knowledge Process Outsourcing |
| LCB | Licensed Commercial Banks |
| MIGA | Multilateral Investment Guarantee Agency |
| MOF | Ministry of Finance and Mass Media |
| MYASD | Ministry of Youth Affairs and Skills Development |
| NBN | National Backbone Network |
| NBT | National Building Tax |
| NRFC | Non-Resident Foreign Currency Accounts |
| OECD | Organization for Economic Co-operation and Development |
| OIA | Outward Investment Account |
| OSS | One Stop Shop |
| PE | Permanent Establishment |
| PFI | Policy Framework for Investment |
| PIP | Public Investment Programme 2017-2020 |
| PPP | Public Private Partnership |
| RFC | Resident Foreign Currency |
| RNNFC | Resident Non National Foreign Currency Account |
| ROC | Registrar of Companies |
| SAARC | South Asian Association for Regional Cooperation |
| SAFTA | South Asia Free Trade Area |
| SAPPTA | Spices and Allied Products Producers and Traders Association |
| SAPTA | South Asian Preferential Trade Agreement |
| SIA | Securities Investment Account |
| SLASSCOM | Sri Lanka Association of Software and Service Companies |
| SLFPA | Sri Lanka Food Processing Association |
| SLFTA | Sri Lanka Pakistan Free Trade Agreement |

| Acronym | Definition |
|---------|---|
| SLNAC | Sri Lanka National Arbitration Centre |
| SME | Small and Medium-sized Enterprise |
| SVAT | Simplified VAT |
| SWIAC | Single Window Investment Approval Committee |
| TIEP | Temporary Importation for Export Processing Zone |
| TIN | Taxpayer's Identification Number |
| TPRU | Transfer Pricing Regulations Unit |
| TRIPS | Trade Related Aspects of Intellectual Property Rights |
| TVET | Technical and Vocational Education and Training |
| UNICTAL | United Nations Commission on International Trade Law |
| VAT | Value Added Tax |
| WTO | World Trade Organization |

Map of Sri Lanka



Source: Perry-Castaneda Library, Map Collection, University of Texas at Austin

1 Outline of Survey

1.1 Purpose of the Survey

The survey aims to collect information in relation to the investment climate of Sri Lanka through the examination of the current FDI environment, potential investments and interests of prospective foreign investors including Japanese investors, in order to promote further FDI into Sri Lanka.

1.2 Survey Background

Sri Lanka has recorded a real GDP growth rate of 8 to 9% a year from 2012 since the end of a three-decade old civil war which ended in 2009. This economic growth, driven by an increase in tourism and other service industries, has continued to grow at around 5% during the past three years.

However, the primary contributors to the recent economic growth are non-tradable, such as the construction and retail industry. Major export industries, such as tea and apparel are continuing to be low value-adding industries due to traditional methods of production being highly dependent on labour. The foreign direct investments (FDI) rely heavily on the infrastructure and service sector, and not into sectors which would contribute to the advancement of Sri Lanka's domestic industry in the global value chain. Export is indispensable for the Sri Lankan economy to maintain sustainable economic growth as the domestic market is small in scale. The country still has room to benefit from its geographical location that has proximity to the Indian market and potential to be the maritime hub connecting Asia and Middle East. As a result, Sri Lanka's share in the global export trade remains less than 0.1% in contrast to the other South Asian and ASEAN countries which are well integrated into the global value chain.

According to the Prime Minister's statements on economic policy delivered on November 2015 and October 2016 subsequent to the inauguration of the new administration, the Government of Sri Lanka would revise the trade and investment policy to ensure that it is in line with sustainable development. The country is pursuing an integration of the domestic industry into the global supply chain and hoping to develop a higher value added manufacturing industry in addition to the reinforcement of the existing sewing and tourism industry. With regard to FDI, the Government is promoting reforms to the investment environment and is currently working on eliminating investment obstacles through an establishment of a one-stop system to avoid complicated permission procedures. Furthermore, the Government is trying to simplify the trade procedures and achieve international standardization based on WTO rules in order to promote further trade.

JICA signed a yen loan agreement, "Development Policy Loans (Private Sector Development, Governance Improvement, and Fiscal Consolidation)" (hereinafter referred to as "DPL") in October 2016, and has been providing support for policy and institutional reforms in collaboration with the World Bank (WB). These policy and institutional reforms are in line with the policy program under the Extended Fund Facility (EFF) agreed upon by the International Monetary Fund (IMF) in June 2016.

Meanwhile, JICA is dispatching investment promotion advisors to the Board of Investment (hereafter referred to as the BOI) since 2014 to provide support in improving the investment environment for FDI promotion. The study needs to assess the current investment climate and identify issues and counter-measures to improve the investment environment.

1.3 Survey Structure

1.3.1 Survey Structure

This survey will be conducted as per the following structure.

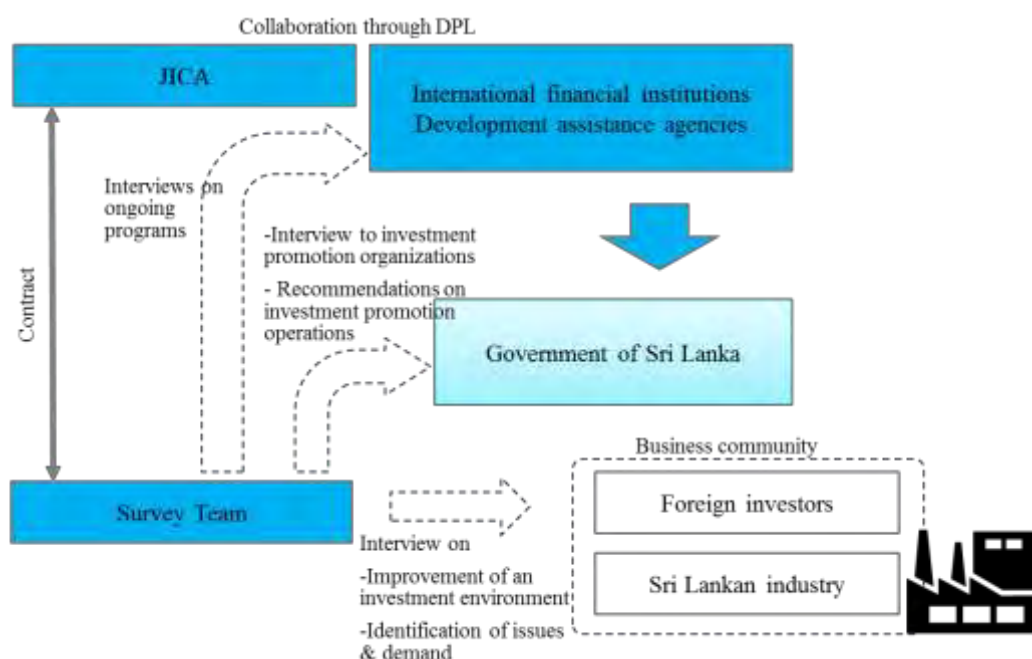


Figure 1-1 Structure for conducting this survey

Source: Survey team

Table 1-1 Organizations involved in this survey

| Relevant organization | | Expected contributions to this survey |
|--|---|---|
| Relevant ministry or agency | <ul style="list-style-type: none"> Ministry of National Policies and Economic Affairs | This Ministry, as the organization overseeing management of the economy of Sri Lanka, will provide an indication on the fields and sectors to which it will guide FDI, in line with the government's financial policy. |
| | <ul style="list-style-type: none"> Ministry of Development Strategies and International Trade Board of Investment | These organizations will provide an indication on the fields to which the FDI should be attracted in order to develop export industries within Sri Lanka which will enable resolving the trade imbalance. |
| | <ul style="list-style-type: none"> Ministry of Finance and Mass Media Central Bank of Sri Lanka Sri Lanka Customs Inland Revenue Department | The Ministry of Finance and Mass Media along with the Central Bank, to provide indication on the management of macroeconomic policy. The Customs and the Inland Revenue Department to provide suggestions on goals and approaches of trade rules and the taxation policies. |
| Donors from various countries, international financial institutions, development assistance agencies such as U.N. agencies | | JICA and other donors from various countries as well as international financial institutions to improve the macroeconomic management, public financial management, and the investment climate in Sri Lanka. Suggestions on holistic approach to improve the macro-economy, balance of payment and trade balance to be achieved through collaboration with the above mentioned Sri Lankan government agencies and international organizations. |

Source: Survey team

1.3.2 Survey Workflow

The workflow of this survey is shown below in chronological order.

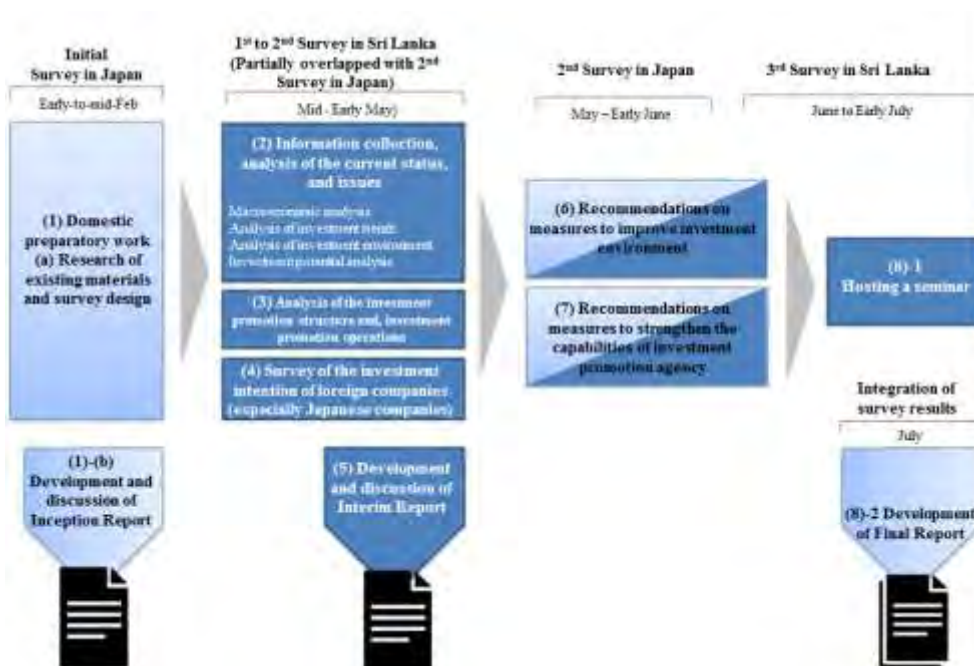


Figure 1-2 Survey workflow

Source: Survey team

1.3.3 Interviews

Throughout this survey, 3 interview surveys in Sri Lanka, and one seminar was conducted. Below table shows some of the main entities interviewed.

Table 1-2 Status of Hearing Interviews

| | |
|---------------------------------|---|
| Government entities (Sri Lanka) | Export Development Board: EDB, Board of Investment: BOI, Agency for Development, Ministry of Finance and Mass Media: MOF, Inland Revenue Department: IRD, Ministry of National Policies and Economic Affairs, Department of National Planning, Prime Minister's Office, etc. |
| Donors, International Agencies | Embassy of Japan in Sri Lanka, JETRO, ADB, World Bank, IFC, Ceylon Chamber of Commerce, Embassy of Netherlands in Sri Lanka, International Development Group, Institute of Policy Studies of Sri Lanka, Colombo Law Alliance, Strategic Management Alliance, JASTECA, Multilateral Investment Guarantee Agency, Sri Lanka Association of Software Service Companies, Sri Lanka Food Processors Association, Joint Apparel Association Forum |
| Private companies | 24 entities |

Source: Survey team

2 Overview of Sri Lanka

2.1 Institutional Structure of the Government

2.1.1 Government Structure

Sri Lanka’s administrative system comprises a central government and nine provincial governments. The central government consists of 51 ministries, and 46 ministers are being appointed. The Cabinet of Sri Lanka is the head of the government, and the Prime Minister oversees the Cabinet. The Prime Minister’s Office was established as an organization under direct control of the Prime Minister, where in some cases, advisors, in addition to the Prime Minister come together to form committees to handle foreign investment projects and other special issues.

The following three organizations are the primary bodies involved in attracting foreign investment.

- (1) Ministry of Development Strategies and International Trade
- (2) Board of Investment
- (3) Export Development Board

Section 3.1 provides a detailed overview of organizations involved in attracting foreign investment.

2.2 Macro economy of Sri Lanka

2.2.1 GDP and Current Account Balance

The Sri Lankan economy grew roughly 8% to 9% in terms of real GDP from the end of the civil war in 2009 until 2012, and has maintained a growth rate of 4% to 5% since then.

The nominal GDP doubled in the most recent seven-year period, which had USD 81 billion in 2015. GDP per capita is also increasing, reaching USD 3,850 in 2015.

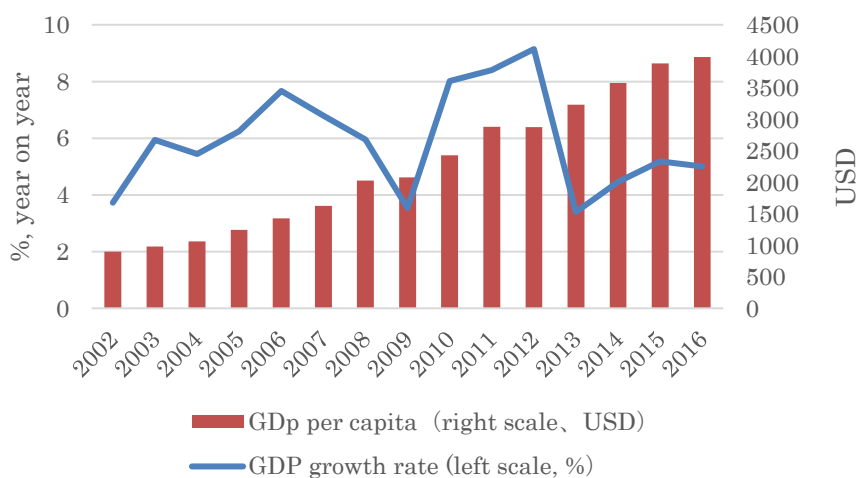


Figure 2-1 GDP Growth Rate and GDP per Capita

Source: IMF, World Economic Outlook (2016)

In terms of external sectors, the deficit of the current account balance also decreased over the seven-year period since 2011. As for the import and export of goods, the export of black tea and other agricultural products has remained slow, but is balanced out by a reduction in the import of fuel and other goods. As for the export of services, income from the tourism sector has increased over the seven-year period. In addition, the inflow of foreign remittances has had a positive impact on the current account balance.

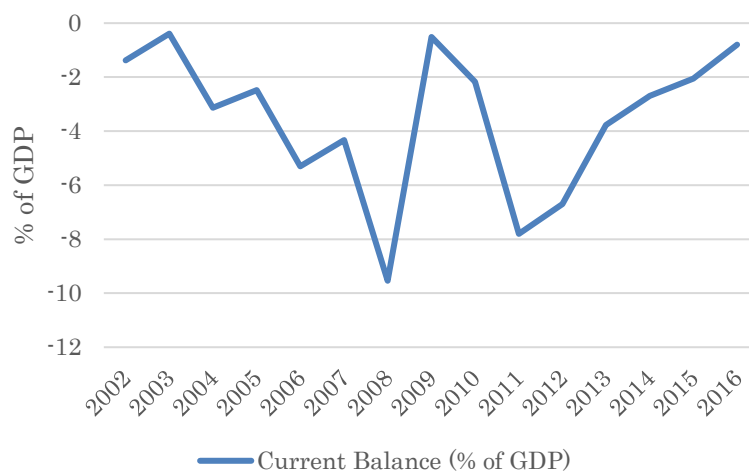


Figure 2-2 Current Balance

Source: IMF, World Economic Outlook (2016)

2.2.2 Fiscal Balance

Expenditures of the Sri Lankan treasury consistently exceed income, and the treasury budget continues to run a deficit. According to IMF, Sri Lanka's budget deficit in 2016 was 5.4% of the GDP.



Figure 2-3 Fiscal Balance

Source: IMF, World Economic Outlook (2016)

The persistent budget deficit has caused outstanding government debts to increase, and IMF estimates that the accumulated debt reached 9.4 trillion LKR in 2016. This is roughly 77% of the country’s GDP.

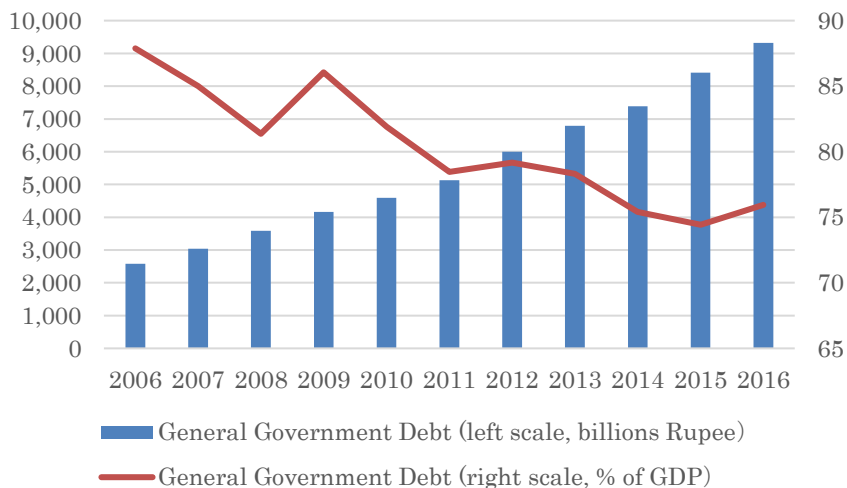


Figure 2-4 General government debt

Source: IMF, World Economic Outlook (2016)

Note that this debt does not include the debt of state owned enterprises. It is said that some portion of the debt is guaranteed by the government, therefore some clarification on the financial situation of SOEs are desirable.

The prompt repayment of debt in the medium and long term is an important policy matter for the Sri Lankan government. For example, the Budget Speech given in November 2016 contained the following: “The Burden of the Public Debt has been a matter of grave concern to this government. This government is committed to relieve the burden of the debt from our children.” In addition, in the field survey of February 2017, the Sri Lankan MOF and Agency for Development indicated that financial situation are among the most important issues that Sri Lanka faces.¹

The Sri Lankan government has raised tax revenues from 12% of GDP in 2015 to 13% in 2016, and is aiming at increasing them to 18% by 2020, and is streamlining expenses in an effort to contain the budget deficit to less than 3% of GDP by 2020. The government also aims to reduce outstanding debt to less than 65% of GDP by 2020.

¹In field interviews conducted in February 2017, the top executive officers of the Agency for Development said, “Sri Lanka faces two challenges: rebalance and reconstruction. ‘Rebalance’ is the improvement of financial and foreign exchange reserves, and ‘reconstruction’ is the revitalization of exports and the elimination of the gap between regions.”

The Sri Lankan government took out 10-year loans of USD 1 billion each year from 2010 and 2012, and took out a five-year loan of USD 1.5 billion in 2014 in an effort to balance the budget deficit. As a result, repayments are concentrated in the period from 2019 to 2022.

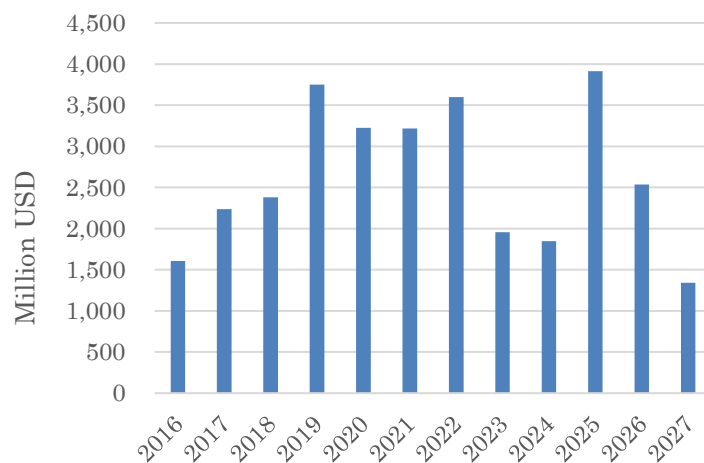


Figure 2-5 Foreign debt servicing schedule

Source: MOF, Budget Speech (2017)

Given that foreign-currency debt accounted for roughly 40% of all public debt (and 29.2% of GDP) as of 2015, the government must reduce the cost of foreign exchange and increase its revenues in order to repay its debts on schedule.

Table 2-1 Central government debt (currency breakdown)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|--|------|------|------|------|------|------|------|
| Central government debt (As a percent of GDP) | 70.7 | 76.0 | 77.2 | 75.5 | 73.1 | 70.7 | 68.2 |
| Domestic currency (As a percent of GDP) | 41.6 | 41.1 | 41.0 | 39.7 | 37.2 | 35.6 | 34.3 |
| Foreign currency (As a percent of GDP) | 29.2 | 35.0 | 36.2 | 35.7 | 35.8 | 35.2 | 33.9 |

Note: Figures after 2015 are estimates by IMF

Source: IMF (2016), *Staff Report for the 2016 Article IV Consultation and Request for a Three Year Extended Arrangement under the Extended Fund Facility*

The following figure shows policy issues for Sri Lanka. It illustrates the relationship of public debt and related issues. The figure was created based on the Survey team’s dialogue with relevant personnel of the Sri Lankan government.

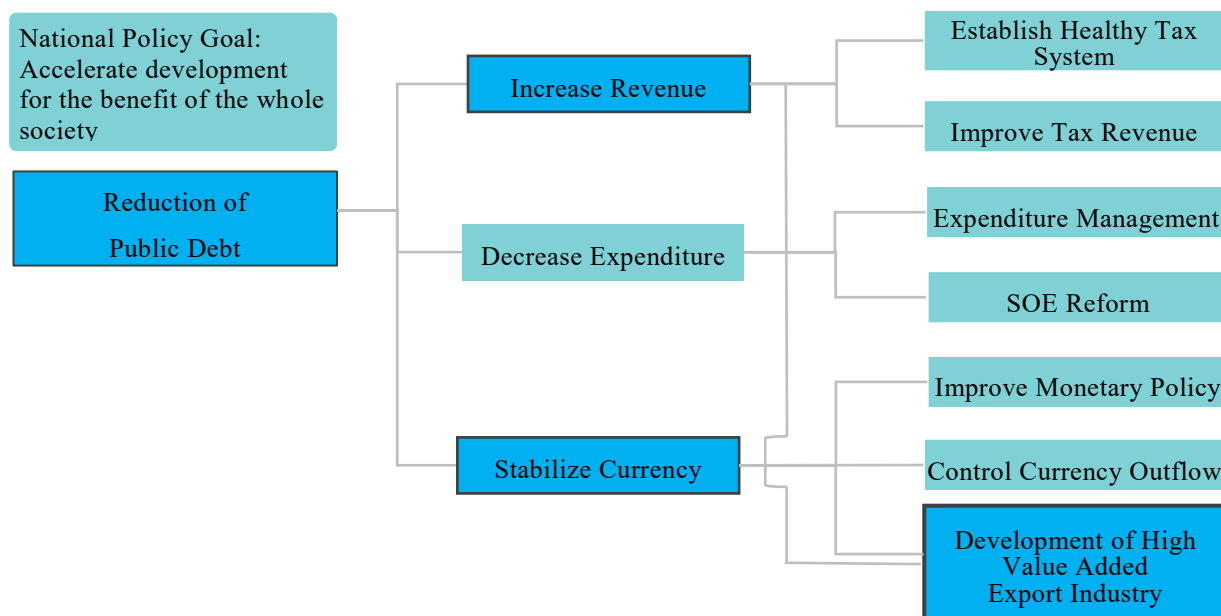


Figure 2-6 Sri Lanka’s policy challenges and corresponding actions
 Source: Prepared by the Survey team

The development of industries is expected to be enhanced through the investment of foreign capital by foreign companies. This will improve the supply-demand balance between foreign currencies and LKR in the short term, which will reduce the risk of depreciation of Sri Lankan Rupee. Over the long term, the development of industry is expected to stabilize the Sri Lankan Rupee from trade balance improvement and a more competitive Sri Lankan export, achieved through development of local skilled labour and spill over effect to local companies. The expansion of export industries should also increase tax revenues as production and incomes increase.

2.3 Orientation of Economic Development Policy and National Land Development

2.3.1 Basic Policy for National Land Development

Since the publication of the Mahinda Chinthana, no foundation of national growth policy has been developed in Sri Lanka. The current administration has put forth the following basic documents regarding policy for economic growth, and all government institutions refer to these documents as well as economic policy documents.

- Public Investment Programme 2017-2020: PIP
- Budget Speech 2017 (Published November 2016)
- Prime Minister's Economic Statement 2016 (Published October 2016)
- Economic Policy of the Government 2015 (Published January 2015)
- National Trade Policy (Draft) (Published September 2016)

In the Economic Policy of the Government 2015, the new administration set out the economic positioning of Sri Lanka takes into account its geopolitical positioning, and touched upon the economic development of the Sri Lankan supported by foreign investment inflows.

The document stresses the need to “break free from poverty and backward thinking, and to attract foreign direct investment to help develop Sri Lanka’s economy by developing its national land,” and offers a specific vision of “developing airports and harbours to make Sri Lanka a hub of export activity, thereby turning it into a crucial junction of the region and of the world.” The document also provides the following points for the well-balanced development of national land.

- Creating regional development corridors
- Entering Global Value Chains
- Providing facilities towards the setting up of businesses
- Strengthening human resources
- Upgrading the fisheries and agricultural sectors to meet international standards
- Evolving a strong and up-to-date digital technology
- Setting up new industrial zones
- Encouraging a greater development in tourism island-wide
- Laying the foundation for a society that promotes equal opportunities for all

In addition, PIP serves as a document that explains policy orientation in more detail. The PIP mentioned the speech given by the Prime Minister on November 5, 2015, and set out five goals: (1) To create employment opportunities for 1 million people; (2) To improve income levels; (3) To stimulate regional economies; (4) To allow farmers, the middle class and government agency workers to own land; and (5) To create a middle class. The beginning of the document describes the attraction of direct investment as the key to achieving these goals, and as particularly important to achieving the first three goals. PIP outlines the development of the country from 2017 to 2020 by sector. This outline is created based on the awareness on how to allocate Sri Lanka’s limited financial resources to execute large-scale projects that are unable to complete within a single year.

Above all, PIP devotes as much attention to the well-balanced economic development, as the Prime Minister's Economic Statement 2016, and the Economic Policy of the Government 2015. Economic development tends to favour the Western Province which includes the Colombo District, accounting for over 40% of Sri Lankan GDP, and over 60% when combined with the second-ranked Southern Province (which includes Hambantota), and the third-ranked Central Province (which includes Kandy). Provinces with lower GDP rates on this list, have higher poverty rates; whilst clean water, electricity and other infrastructures rate highly developed in the richer provinces, and lower in the poorer provinces. These circumstances suggest that the Sri Lankan economy is concentrated in the Western Province, and that development is not progressing in the other areas.

Table 2-2 Major Development Factors by Area

| | GDP Break Down (2015) | Poverty Rate | Unemployment Rate | Waterworks Development Rate | Electrification Rate |
|----------------|-----------------------|--------------|-------------------|-----------------------------|----------------------|
| | % | % | % | % by population | % by household |
| Western | 41.2 | 2.0 | 3.7 | 58.7 | 100.0 |
| Central | 11.0 | 6.6 | 4.3 | 49.7 | 98.0 |
| Southern | 10.4 | 7.7 | 5.9 | 53.9 | 100.0 |
| Northern | 10.3 | 10.9 | 5.3 | 9.3 | 94.0 |
| Eastern | 7.0 | 11.0 | 4.9 | 47.2 | 94.0 |
| North Western | 6.0 | 6.0 | 4.4 | 24.0 | 97.0 |
| North Centyral | 5.4 | 7.3 | 3.3 | 47.0 | 98.0 |
| Uva | 5.2 | 15.4 | 2.9 | 42.2 | 97.0 |
| Sabaragamuwa | 3.5 | 8.8 | 5.5 | 22.7 | 99.0 |

Source: Survey team based on PIP

In light of these circumstances, the Prime Minister's economic policy document of January 2015 mentions two primary economic corridors and one secondary corridor that will serve to balance out the uneven distribution of development throughout the country. In order of priority, they are the South Western Economic Corridor, the North Eastern Economic Corridor, and the Upcountry Secondary Corridor. Multiple plans for further development are incorporated into the development of each corridor. PIP also touches upon the well-balanced development of the entire country through corridor development in relation to industrial promotion.

2.4 Industrial Development

The figure shows the share of GDP for each industry in Sri Lanka.

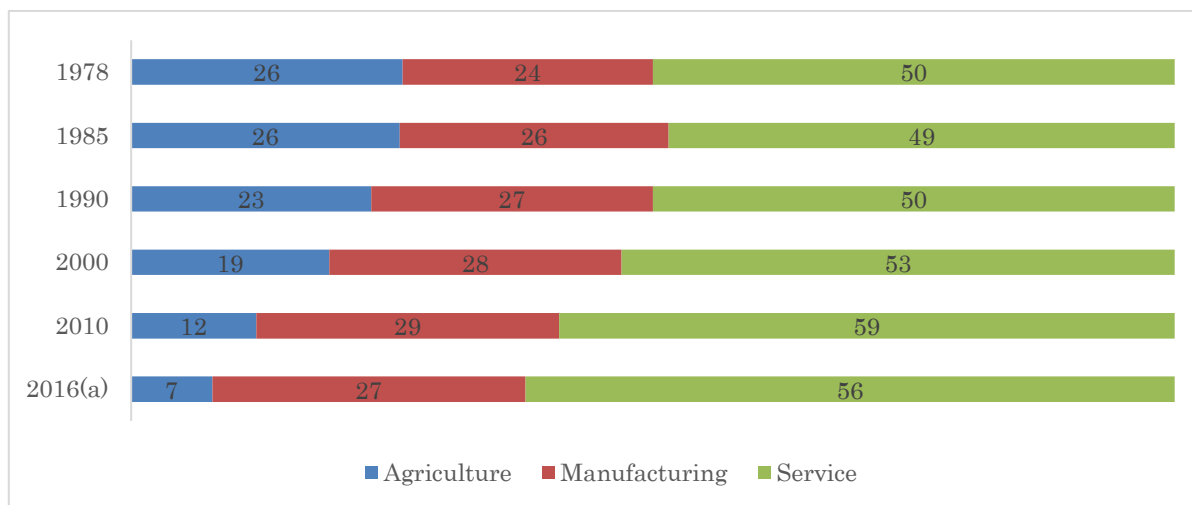


Figure 2-7 GDP Breakdown (1978 – 2015)

Source: Sri Lanka Department of Census and Statistics, Central Bank of Sri Lanka (2015)

Figure 2-7 shows the proportional degree to which each industry contributes to the GDP of Sri Lanka. The share of agriculture, which depends largely on black tea, palm, rubber and other plantation products, has decreased, whilst the service industry now accounts for nearly 60% of the GDP. Products from both sectors have little added value; a challenge for Sri Lanka is to develop industries that create high value-added products for exports.

2.4.1 Industry Promotion Policy and Plans

The fourth chapter of PIP is entitled “Industry, Trade, Investment and Tourism,” and Section 4.1.3: Policy Directions explains the orientation of industry promotion policy. The document calls for providing assistance to the private companies (and not state owned enterprises), in particular to the export oriented industries toward a more efficient production of wide variety of high value-added products for export. The document also mentions the development of import substitution industries by small and medium-sized enterprises (SMEs) in Sri Lanka. Specific measures for achieving these goals include development of industrial infrastructure, forming policy frameworks and development of investment climate. Although PIP named out following industries as “key areas”, no definite development strategies nor planning are presented in the PIP.²

In the midst of this situation, the World Bank, AusAID (the Australian Agency for International Development), and the Harvard University Development Research Centre have each conducted research on

² PIP named out Key areas as follows; oil refinery, renewable energy, integrated car manufacturing, manufacturing steel bridges for the region, fertilizer and manufacturing triple super phosphate, satellite technology, air craft repair and logistical support, pharmaceutical industry (p.65, PIP, Department of National Planning, Ministry of National Policies and Economic Affairs)

industries that should be promoted in Sri Lanka, in an effort to improve the country's competitiveness. The World Bank and AusAID presented their findings in Colombo in November 2016, and the research results from Harvard University are being used by a team comprised within the BOI as reference in their investment promotion activities. Note that the research results of Harvard University are scheduled to be finalized by August 2017.

As for specific industries, the information industry is shifting to add value in their business process rather than business process outsourcing (BPO) that has taken root in Sri Lanka conventionally. The life sciences industry is focusing on pharmaceutical production, taking advantage of Sri Lanka's geographical location and the business environment which is conducive to product quality management. However, it is difficult to accurately define the industry forecast, since some providers still offer treatment incorporating traditional Ayurveda techniques as life science treatment. In addition, the Harvard University research used simplified biaxial evaluation to reveal promising industries capable of impacting the Sri Lankan economy and competing in the global market. These nominated industries include photovoltaic panel production, exporting and medical equipment manufacturing. Whilst the rationale of these choices were not clear, the BOI has already been engaged in promotion of nominated industry to the potential investors.

The World Bank and AusAID named the following eight industries in their research.

1. Automotive components
2. Food processing industry
3. High value added apparel, textile and related Services
4. High value added rubber products
5. ITES³
6. Life science industry
7. Logistics
8. Tourism

As explained previously, to foster export-oriented industries; Sri Lanka is moving toward the production of higher value-added products, even in food production, rubber and other conventional manufacturing industries developed throughout the country. For the information and logistics industries as well, the country is considering the possibility of establishing industries that can provide higher value-adding services and processing rather than relying solely on conventional business outsourcing.

Most institutions interviewed during this study are seeking a course for future industry promotion based on research findings presented in November 2016.⁴

³ Information Technology Enabled Services

⁴The Ceylon Chamber of Commerce (CCC) made the same comments as the BOI.

As with FDI, Sri Lankan foreign trade policy is under the purview of the Ministry of Development Strategies and International Trade. The promotion of exports is one of the responsibilities of the Export Development Board (EDB). The Ministry of Development Strategies and International Trade’s foundational policy document is the Mid-term Strategic Trade Policy Framework, which sets out trade policies and strategies from 2016 to 2020. This document lists the goals of export expansion, improvement of competitiveness, a transition to a private sector-led economy, and expansion of the country’s share of regional and global trade. The EDB, which is the implementing agency of trade policy, has developed (but not yet publicized) an action plan.

2.5 Trade Policy

In monetary terms, Sri Lanka’s exports doubled between 2001 and 2015. Industrial products account for 80% of the export amounts, and 60% of that amount is related to sewing, while 20% is agricultural products. Black tea, spices and coconuts account for 80% of agricultural product exports; low-value-added products account for the majority of exports. In contrast, the domestic labour shortage has driven the apparel and sewing industries to venture into Turkey, Jordan and other Middle and Near Eastern countries in an effort to maintain production capacity.⁵

These trade statistics also demonstrate the need to advance industry by developing new export oriented industries, and to stabilize the macro economy as explained previously by earning foreign currency. In addition, the country should shift its industrial structure from exporting low value added products to export oriented industries through structural reform and advancement.

In addition to joining the World Trade Organization on January 1, 1995, Sri Lanka has entered regional cooperation relationships with neighbouring countries as shown in Table 2-2. As for bilateral Free Trade Agreements, Sri Lanka has concluded FTAs with India and Pakistan. In addition, both China and Sri Lanka signed a Memorandum Regarding the Commencement of Negotiations for a China-Sri Lanka Free Trade Agreement in September 2014, and have officially begun FTA negotiations toward the conclusion of the agreement.

The country has also joined multilateral economic partnerships, namely partnerships with South Asian nations as shown in the table.

Table 2-3 Sri Lanka's Economic Partnership Agreement

| Agreement | Year of agreement | Member states | Overview |
|--|-------------------|---|--|
| South Asian Association for Regional Cooperation (SAARC) | 1985 | Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka | Agreement of cooperation mainly in agriculture development, transportation and communication, social development, environment, science and technology, human resource development, energy. |
| South Asia Free Trade Area (SAFTA) | 2006 | Bangladesh, Bhutan, India, Maldives, Nepal, | Trade liberalization program of SAARC enabling reduction of import tax. |

⁵Study Team interview (Candor) and p.98 The Report 2016, Oxford Business Group, 2016

| Agreement | Year of agreement | Member states | Overview |
|--|-------------------|--|--|
| | | Pakistan, Sri Lanka | |
| South Asian Preferential Trade Agreement (SAPTA) | 1995 | Bangladesh, Bhutan, Maldives, Nepal, Sri Lanka | As the first step to reduce customs, 10% tariff on import goods from LDCs (Bangladesh, Bhutan, Nepal, and Maldives) reduced. 30% reduction as the second step from 31 st December 2006. |
| Asia Pacific Trade Agreement (APTA) | 1997 | Bangladesh, India, Korea, Lao, China, Sri Lanka | Based on the rules of origin, specific goods from member states apply under preferential tariff. |
| The Global System of Trade Preference (GSTP) | 1989 | Algeria, Bangladesh, Benin, Bolivia, Brazil, Cameroon, Chile, Cuba, Singapore, Sri Lanka, etc. (overall 40 states) | Economic partnership to enhance trade among developing countries by applying preferential tariffs on 1,626 agricultural, industrial goods. |
| Indo-Sri Lanka Free Trade Agreement (ISFTA) | 2000 | India, Sri Lanka | India abolished custom duties on 5,223 goods excluding that on the negative list in March 2005. Sri Lanka abolished custom duties on 4,026 items in 2008. |
| Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) | 2004 | Bangladesh, India, Myanmar, Sri Lanka, Thailand, Nepal, Bhutan | Agreement among 7 states including the abolishment of custom duties. |
| Sri Lanka-Pakistan Free Trade Agreement (SLPFTA) | 2005 | Pakistan, Sri Lanka | Custom duties on 206 goods from Pakistan, 102 goods from Sri Lanka abolished. |

Source: Survey team, based on JETRO WTO•Other Agreements

The EDB has named the electrical and electronics, auto parts and food product processing industries as industries to develop for the promotion of exports, and plans to devote energy to industrial development, but has also named several other industries to which it will provide policy support as export promotion industries. For example, the organization is currently looking into issues such as the aging of production equipment, and exporting market development. Acquisition of certifications such as HACCP and supporting procurement of facilities are specific areas being tackled.

2.6 Foreign Direct Investment (FDI)

2.6.1 Current FDI Status

The FDI flow to Sri Lanka since 2011 is shown in Figure 2-8. The total inflow shows a steady increase from 2011 to 2015, however decreases in 2015. As shown in Table 2-4, the total approved FDI to Sri Lanka this year was only USD 969.7 million, which was a decline of 36.6% from the previous year. The declines of the inflow to the service sector (-49.6%) and the infrastructure sector (-33.6%) were particularly significant, and the manufacturing industry, as a whole, saw a decline of 22.0% from the same period of the previous year. Analysing the inflow record in 2015 based on the constituent ratio of each sector against the total, investments in the infrastructure sector (investments for housing, real estate and shops and

telecommunication-related investments) account for almost half the whole inflow, followed by the investments in hotels and restaurants. These are reflecting the construction boom of luxury hotels and commercial complexes in Colombo area (including the suburbs) invested by foreign capital, which has been underway since 2012. On the other hand, while the constituent ratio of the inflow of FDI to the manufacturing industry shows a year-on-year increase. Although the inflow of foreign capital to the processing of agricultural products, textile, apparel and leather industries and agriculture, which are major export industries of Sri Lanka is minimal.

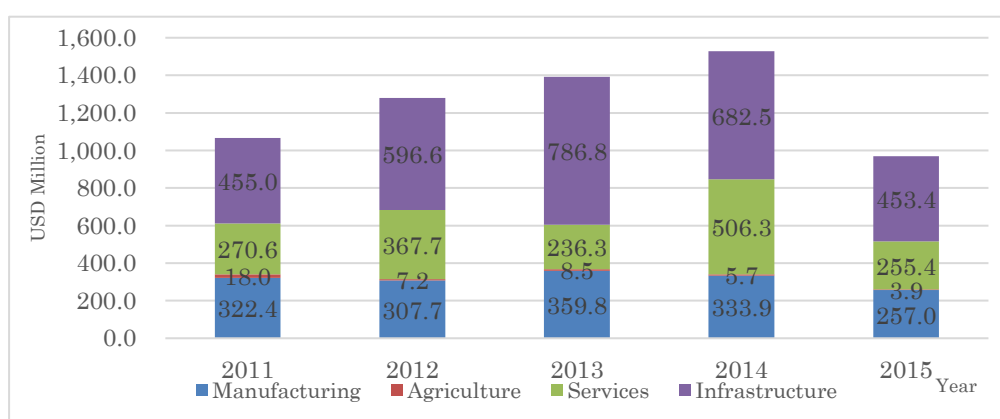


Figure 2-8 Foreign Direct Investment into Sri Lanka (2011 to 2015)

Source: Central Bank of Sri Lanka, Annual Report 2015, Statistical Appendix

Table 2-4 FDI amount in industry approved by BOI (Year on Year, Flow)

| Sector | US\$ million | | | | | |
|---|----------------|---------------|--------------|---------------|----------------|---------------|
| | 2014 | | 2015 | | 2014vs2015 | |
| | Amount | Ratio | Amount | Ratio | Amount | % |
| Manufacturing | 333.9 | 21.8% | 257.0 | 26.5% | (76.9) | -23.0% |
| Food, Beverages and Tobacco Products | 44.7 | 2.9% | 42.7 | 4.4% | (2.0) | -4.5% |
| Textile, Wearing Apparel and Leather Products | 83.1 | 5.4% | 45.4 | 4.7% | (37.7) | -45.4% |
| Wood and Wood Products | 2.5 | 0.2% | 2.8 | 0.3% | 0.3 | 12.0% |
| Paper, Paper Products, Printing and Publishing | 36.3 | 2.4% | 2.2 | 0.2% | (34.1) | -93.9% |
| Chemicals, Petroleum, Coal, Rubber and Plastic Products | 91.9 | 6.0% | 75.4 | 7.8% | (16.5) | -18.0% |
| Non-metallic Mineral Products | 29.7 | 1.9% | 13.7 | 1.4% | (16.0) | -53.9% |
| Fabricated Metal, Machinery and Transport Equipment | 7.0 | 0.5% | 46.1 | 4.8% | 39.1 | 558.6% |
| Manufactured Products not elsewhere specified | 38.7 | 2.5% | 28.7 | 3.0% | (10.0) | -25.8% |
| Agriculture | 5.7 | 0.4% | 3.9 | 0.4% | (1.8) | -31.6% |
| Services | 506.3 | 33.1% | 255.4 | 26.3% | (250.9) | -49.6% |
| Hotels and Restaurants | 68.4 | 4.5% | 181.9 | 18.8% | 113.5 | 165.9% |
| IT and BPO | 24.7 | 1.6% | 13.6 | 1.4% | (11.1) | -44.9% |
| Other Services | 413.3 | 27.0% | 59.9 | 6.2% | (353.4) | -85.5% |
| Infrastructure | 682.5 | 44.7% | 453.4 | 46.8% | (229.1) | -33.6% |
| Housing, Property Development and Shop Office | 339.2 | 22.2% | 212.1 | 21.9% | (127.1) | -37.5% |
| Telephone and Telecommunication Network | 152.5 | 10.0% | 138.8 | 14.3% | (13.7) | -9.0% |
| Power Generation, Fuel, Gas, Petroleum and Other | 12.5 | 0.8% | 51.3 | 5.3% | 38.8 | 310.4% |
| Port Container Terminals | 178.2 | 11.7% | 51.2 | 5.3% | (127.0) | -71.3% |
| Total | 1,528.4 | 100.0% | 969.7 | 100.0% | (558.7) | -36.6% |

Source: Central Bank of Sri Lanka Annual Report (2015)

It should be noted that the data of FDI in Table 2-4 represent the amounts approved by the BOI. They include loans to target companies, except the inflow of investments to non-BOI companies, and direct

investments to non-BOI companies listed on the Colombo Stock Exchange. Also, the figures of 2015 are provisional values.

With respect to the FDI by country in the same period, the top 10 countries in terms of the year-on-year difference are listed below. The sharp drop from 2014 to 2015 (USD -558.7 million) was the result of significant decrease in the inflow of investments from the U.K., China and the U.S., contrary to a large capital inflow from Hong Kong. The decrease of inflow from China was mainly caused by the impact of a temporary suspension order of the Colombo Port City Project by the new administration.

Table 2-5 Foreign Direct Investment (FDI) by BOI Companies by Country Year-on-Year Ratio (Flow)⁶

| Country | US\$ million | | | | | |
|-----------------------|--------------|-------------|--------|-------------|------------|---------|
| | 2014 | | 2015 | | 2014vs2015 | |
| | Amount | Composition | Amount | Composition | Amount | % |
| U.K. | 382.5 | 23.7% | 29.0 | 3.0% | (353.5) | -92.4% |
| China | 403.5 | 25.0% | 150.8 | 15.5% | (252.7) | -62.6% |
| Hong Kong | 73.7 | 4.6% | 188.0 | 19.4% | 114.3 | 155.1% |
| U.S.A. | 127.9 | 7.9% | 16.8 | 1.7% | (111.1) | -86.9% |
| Singapore | 102.5 | 6.3% | 30.5 | 3.1% | (72.1) | -70.3% |
| Mauritius | 98.1 | 6.1% | 139.2 | 14.4% | 41.1 | 41.9% |
| British virgin Island | 1.5 | 0.1% | 36.1 | 3.7% | 34.6 | 2371.9% |
| Malaysia | 37.2 | 2.3% | 65.1 | 6.7% | 27.9 | 75.0% |
| Australia | 37.4 | 2.3% | 18.6 | 1.9% | (18.8) | -50.3% |
| India | 51.8 | 3.2% | 67.8 | 7.0% | 16.0 | 30.9% |
| Other | 300.1 | 18.6% | 227.8 | 23.5% | (72.3) | -24.1% |
| Total | 1,616.3 | 100.0% | 969.7 | 100.0% | (646.6) | -40.0% |

Source: Survey team, based on information from the Board of Investment of Sri Lanka

The balance of payments of Sri Lanka is shown below by year on year basis, which is prepared in accordance with the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6). The figures of 2015 are provisional values.

FDI amount by BOI companies stated in Table 2-5 is different from the amount in Table 2-6. This is reflecting the fact that figures on Table 2-5 is the amount of investment at approval stage, whilst figures in Table 2-6 is the amount of investment actually transferred.

Table 2-6 FDI amount based on BPM6 presentation format (Year on Year, Flow)

| Item | US\$ million | | | | | |
|--------------------------|--------------|--------|--------|--------|------------|----------|
| | 2014 | | 2015 | | 2014vs2015 | |
| | Amount | Ratio | Amount | Ratio | Amount | % |
| Equity investments | 88 | 9.9% | 85 | 12.5% | (3.0) | -3.4% |
| BOI companies | 10 | 1.1% | 36 | 5.3% | 26.0 | 260.0% |
| Non-BOI companies | (15) | -1.7% | 62 | 9.1% | 77.0 | 513.3% |
| Other companies | 93 | 10.4% | (13) | -1.9% | (106.0) | -114.0% |
| Reinvestment of earnings | 380 | 42.6% | 341 | 50.1% | (39.0) | -10.3% |
| Debt instruments | 425 | 47.6% | 255 | 37.4% | (170.0) | -40.0% |
| BOI companies | 424 | 47.5% | 110 | 16.2% | (314.0) | -74.1% |
| Non-BOI companies | 1 | 0.1% | 145 | 21.3% | 144.0 | 14400.0% |
| Total | 893 | 100.0% | 681 | 100.0% | (212.0) | -23.7% |

Source: Central Bank of Sri Lanka Annual Report (2015)

⁶ According to a BOI official, differences in FDI amount of 2014 in table 2-4 and table 2-5 is because the BOI and the Central Bank of Sri Lanka have different categorization of BOI companies and Non-BOI companies.

The result of comparing the number of investments by location (by companies approved by the BOI, stock) in the same period is described in the following. There has been no major change in investment counts by region between 2014 and 2015. Colombo was the largest investment region, and combined with the investments in Gampaha, which is in the suburbs of Colombo, the investments in Colombo account for nearly two-thirds of the total investments. It should be noted that the following data include the investments made in relation to the 50 Regional Garment Factory Project additional investments made by existing companies, and the figures of 2015 are provisional values.

Table 2-7 Foreign Direct Investment (FDI) by BOI Companies by Location Year-on-Year Ratio (Stock)

| District | 2014 | | 2015 | | 2014vs2015 | |
|--------------|--------|-------------|--------|-------------|------------|--------|
| | Counts | Composition | Counts | Composition | Counts | % |
| Colombo | 1,131 | 41.9% | 1,165 | 41.0% | 34 | 3.0% |
| Gampaha | 643 | 23.8% | 671 | 23.6% | 28 | 4.4% |
| Kalutara | 159 | 5.9% | 170 | 6.0% | 11 | 6.9% |
| Galle | 133 | 4.9% | 142 | 5.0% | 9 | 6.8% |
| Puttalam | 94 | 3.5% | 99 | 3.5% | 5 | 5.3% |
| Kandy | 90 | 3.3% | 100 | 3.5% | 10 | 11.1% |
| Kurunegala | 84 | 3.1% | 84 | 3.0% | 0 | 0.0% |
| Matara | 29 | 1.1% | 29 | 1.0% | 0 | 0.0% |
| Hambantota | 29 | 1.1% | 36 | 1.3% | 7 | 24.1% |
| Nuwara Eliya | 57 | 2.1% | 64 | 2.3% | 7 | 12.3% |
| Ratnapura | 50 | 1.9% | 54 | 1.9% | 4 | 8.0% |
| Anuradhapura | 22 | 0.8% | 23 | 0.8% | 1 | 4.5% |
| Badulla | 28 | 1.0% | 33 | 1.2% | 5 | 17.9% |
| Kegalle | 44 | 1.6% | 47 | 1.7% | 3 | 6.8% |
| Matale | 30 | 1.1% | 37 | 1.3% | 7 | 23.3% |
| Moneragala | 9 | 0.3% | 9 | 0.3% | 0 | 0.0% |
| Polonnaruwa | 11 | 0.4% | 11 | 0.4% | 0 | 0.0% |
| Ampara | 15 | 0.6% | 16 | 0.6% | 1 | 6.7% |
| Trincomalee | 22 | 0.8% | 25 | 0.9% | 3 | 13.6% |
| Batticaloa | 7 | 0.3% | 10 | 0.4% | 3 | 42.9% |
| Vavuniya | 6 | 0.2% | 6 | 0.2% | 0 | 0.0% |
| Jaffna | 4 | 0.1% | 4 | 0.1% | 0 | 0.0% |
| Mannar | 2 | 0.1% | 3 | 0.1% | 1 | 50.0% |
| Kilinochchi | 1 | 0.0% | 4 | 0.1% | 3 | 300.0% |
| Mullaitivu | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| Total | 2,700 | 100.0% | 2,842 | 100.0% | 142 | 5.3% |

Source: Survey team, based on information obtained from Board of Investment of Sri Lanka

2.6.2 FDI Related Policies

In “Mahinda Chintana”, which was a major framework of the national growth policy of the previous administration, six hubs (maritime transportation, aviation, commerce, energy, knowledge and tourism) were specified as the bases for the development plan for the 10-year period from 2006 to 2016. More

specifically, in order to achieve the target economic growth of 8% annually, significant increase was expected in the private investment and in particular, increasing it to 5% of the GDP was set forth as a goal. However, analysing the actual amount of FDI as described above, it is observed that while investments to meet the infrastructure demands and foreign tourist demands, which may be regarded as dividends of peace, are increasing, conventional industrial structure, which is dependent on the exports of garments and tea, continues to exist.

At the same time, there are limitations to the inflow of FDI to high-value-added sectors that may lead to exporting more sophisticated products and creating technological innovation. Also, the penetration of FDI into the rural area are extremely limited.

In the draft of the National Trade Policy of Sri Lanka devised in October 2016, trade is identified as a method of achieving the creation of one million jobs, which is mentioned in the Prime Minister's speech. However, the policy draft also points out that Sri Lanka finds itself in the competitive environment of the global economy by virtue of joining bilateral and multilateral trade frameworks, and the policy draft sets out the following five points as measures for Sri Lanka to undertake in such an environment.

- Strengthening bilateral relationship with Asian countries
- Entering into comprehensive regional partnerships
- Linking with global value chains
- Creating opportunities for trade and investment opportunities
- Diversifying exports baskets and exports destinations, and lowering dependency on specific products

There are over 130 Japanese companies (companies with Japanese capital by whatever means) venturing in Sri Lanka as of July 2017, and 71 of those companies are members of chambers of commerce.

Reasons for Japanese companies to develop their business in Sri Lanka vary from employment of high quality workers at a comparatively lower wage, to its geographical characteristics offering superb access to the Indian markets, the Middle and Near East, Europe and Latin America. These business models where Japanese companies have developed high-value added export oriented industries are of interest to industrial associations in Sri Lanka and have hence stimulated investment and discussions.

3 Business Investment Climate

3.1 Government Organizations Involved in Foreign Direct Investment

The Ministry of Development Strategies and International Trade and the BOI are the government ministry and agency in charge of FDI promotion. Additionally, Agency for Development is planned to be placed as an overseeing agency of BOI, although its development act is still in the course of enactment at August 2017. Their overview is provided below.

3.1.1 Ministry of Development Strategies and International Trade

Ministry of Development Strategy and International Trade established based on the gazette "Duties & Functions of Ministries" No. 1933/13 2015 and is responsible to development strategy and international trade policy. The Board of Investment, Sri Lanka Export Development Board, Department of Import and Export Control are under its umbrella.

The responsibilities and purposes of the ministry provided in Gazette#1933/13 are described below.

- Formulation of policies, programmes and projects, monitoring and evaluation in regard to the subjects of Development Strategies and International Trade, and those subjects that come under the purview of Departments, Statutory Institutions
- Formulation of investment promotion programmes and projects
- Promotion of economic potential in Sri Lanka and thereby promote Foreign Direct Investment and private sector investment
- Development of strategies for expansion of international market opportunities for local produce
- Adoption of necessary measures for strengthening international trade relations*
- Formulation of policies, strategies, programmes and projects for the promotion of regional economic cooperation
- Matters relating to multi-lateral and bi-lateral economic agreements*
- Promotion, regulation and monitoring of economic development zones
- Encouragement of export diversification, export development and advisory services
- Representation of Sri Lanka's trade affairs abroad*
- Provision of facilities for higher education to youth community
- Supervision of the Institutions under purview

The Ministry of Development Strategies and International Trade aims to realize a sustainable and consistent investment environment that enables domestic producers to have income in overseas markets and is responsible for formulating measures based on strategic policies for its realization. Specifically, it creates an investment environment through developing domestic legislation, decides the action policy of participating organizations and provides services through the agencies under its umbrella; thereby attracting FDI, exploring overseas markets for domestic producers and strengthening international trading relations through bilateral or multilateral cooperation.

Following is the structure of the ministry.

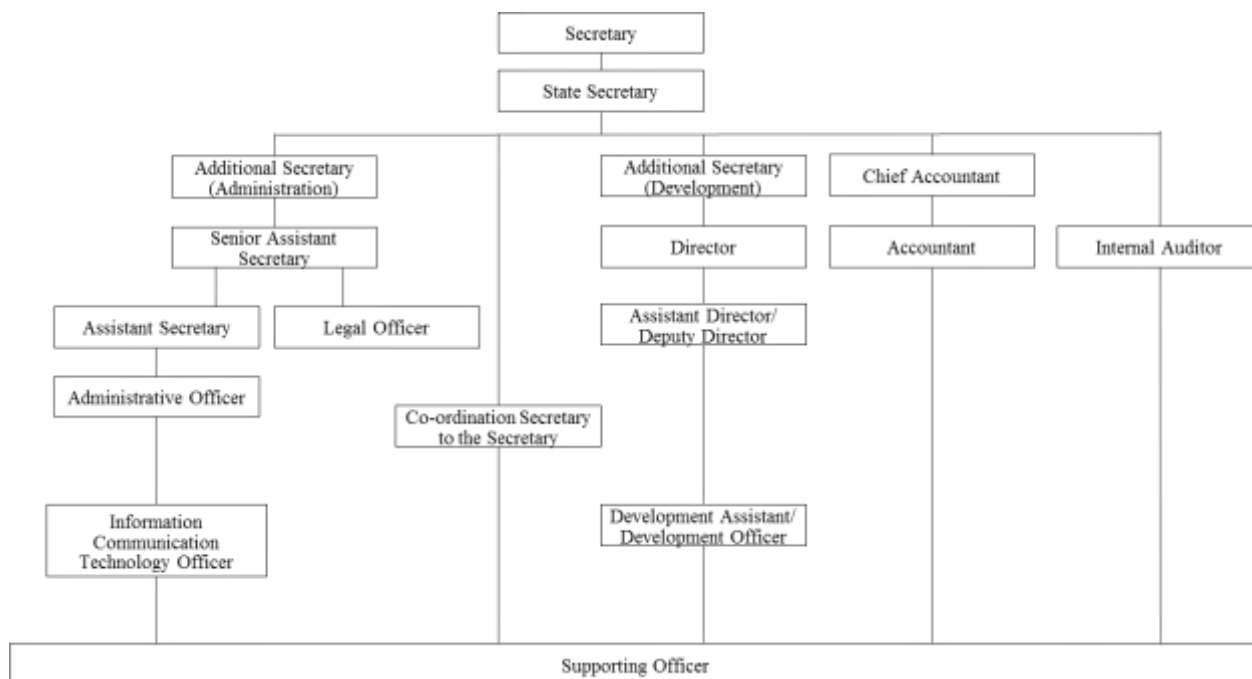


Figure 3-1 Organizational Structure of Ministry of Development Strategies and International Trade Sri Lanka

Source: Annual Performance report 2015, Ministry of Development Strategies and International Trade, Dec.2015⁷

3.1.2 Agency for Development

The Development (Special Provision) Bill that was posted on the government bulletin on November 25, 2016, is to “formulate the national policy and decide matters related to its implementation in order to accelerate economic development of Sri Lanka⁸”. This bill is currently given file number and input a date of first reading in the parliament and has yet to be approved as of August 2017. Therefore, the agency is not at its official operation.

The Development Act is to sort out laws related to economic development and integrate their functions. The Policy Development Office is to be set up to assist the minister for its implementation. It formulates and reviews policies allocates the budget. The minister responsible is required to report their plans to the Cabinet⁹ and the managing director is appointed by the minister as its chief executive¹⁰.

Seven sectors including manufacturing are designated as economic development areas to accelerate economic development based on the national policy, and at the same time, regional heads will be appointed.

The Agency for Development is stipulated in the Development Bill from Articles 14 to 20. Its primary

⁷ Ministry of Development Strategies & International Trade, Annual Performance Report 2015: <https://www.parliament.lk/uploads/documents/paperspresented/performance-report-ministry-of-development-strategies-international-trade-2015.pdf>

⁸ Para.1, p.2, Development Bill

⁹ Art. 2, Development Bill

¹⁰ Art. 4(1), Development Bill

purpose is to stimulate, expand and develop an economy based on the national policy in order to accelerate the economic development stipulated in Article 10. Secondary, to modernize the economic basis of Sri Lanka, following topics are covered¹¹:

- develop overseas market for domestic products,
- increase competitiveness of such goods and services,
- improve the market condition,
- create employment,
- increase income,
- correct trade imbalance,
- promote exports and imports,
- protect consumers,
- realize fair competition,
- enhance competitiveness of domestic enterprises by introducing advanced technologies,
- increase management capacities,
- development of necessary infrastructure for the economy
- finally to report priority issues for enhancing competitiveness to the Cabinet

The Agency for Development has duties to formulate plans for realizing the national policy, negotiate with local governments on regional development and those involved in industrial promotion provided in Article 12, formulate regional development plans, and coordinate with relevant ministries and agencies when needed in order to implement the national policy¹². As for Article 12 in relation to economic development areas, Clause 4 requires companies that are involved in regional development to acquire a certificate from the AFD. Clause 6 stipulates that the AFD supersedes the BOI and EDB in relation to actions to be taken for achieving the purpose. Clause 9 requires companies that wish to conduct development activities through the BOI in an economic development area to apply for a permit with the AFD.

¹¹ Art.15, Development Bill

¹² Art. 16, Development Bill

3.1.3 Board of Investment

The Board of Investment is the successor of the Greater Colombo Economic Commission that was established based on the Greater Colombo Economic Commission Law No.4, 1978. It was reorganized into the BOI in 1992 to promote the economy and industry of the country. It is now operating to promote FDI and exports of Sri Lankan goods to acquire foreign currencies, to invite new technologies through investment promotion activities, and to establish Export Processing Zones (EPZs) across the nation.

Major amendments on BOI Acts since 1992 are as follows;

November 1992 Greater Colombo Economic Commission Amendment Act, No. 49, 1992

- Name of GCEC changed to the Board of Investment and the title of responsible person for the BOI is changed
- Legal guaranty to position BOI superior to private companies.

June 2002 Board of Investment of Sri Lanka Amendment Act, No. 9, 2002

- Insertion of The Inland Revenue Act, No. 38 of 2000 into Schedule B
- Insertion of The National Film Corporation of Sri Lanka Act, No.47 of 1971 into Schedule B

July 2009 Board of Investment of Sri Lanka Amendment Act No. 36, 2009

- Insertion of the Inland Revenue Act, No. 10 of 2006 into Schedule B

February 2012 Board of Investment of Sri Lanka Amendment Act No. 3, 2012

- Titles of board members are amended.

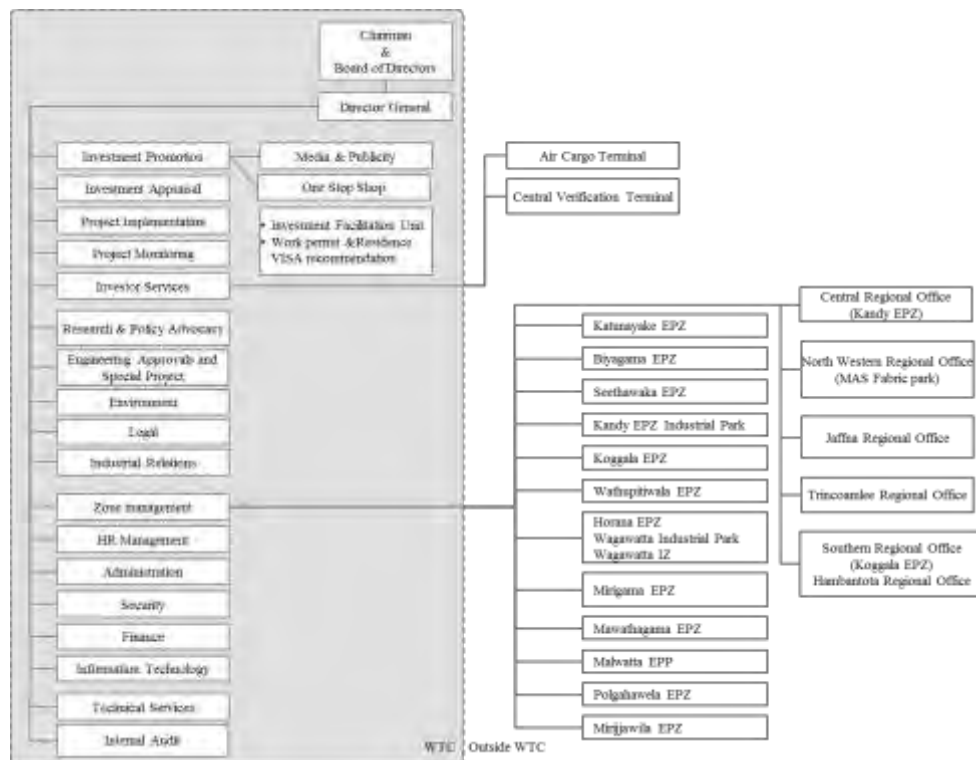


Figure 3-2 Organizational Structure of BOI (August 2017)

Source: Survey team based on information from BOI

The BOI is the core organization in charge of FDI activities, assisting the entry of foreign investors and their operation in Sri Lanka after entry. It consists of 13 divisions with 1,193 employees, of which 452 work at the head office and the remaining employees work at 12 EPZs to manage and provides services for their tenants. The BOI gains income by operating the industrial parks and assisting with export and import procedures of tenants. Its income and expenditures of FY2013 are provided below.

Table 3-1 Comparison of BOI operations between 2012 and 2013

| Category | (Rs. Mn.) | | | |
|-----------------------------------|----------------|----------------|----------------------|-----------|
| | 2012 Figure | 2013 Figure | 2012vs2013 Figure | % |
| Revenue | 2,226.4 | 2,721.8 | 495.4 | 22.3% *1 |
| Expenditure | (2,088.8) | (2,493.4) | (404.6) | 19.4% *2 |
| Results from operating activities | 137.6 | 228.4 | 90.8 | 66.0% |
| Net Finance Income | 130.5 | 85.1 | (45.4) | -34.8% *3 |
| Surplus before Taxation | 268.1 | 313.6 | 45.5 | 17.0% |
| Income Tax expenses | (29.0) | (22.6) | 6.3 | -21.9% |
| Surplus for the year | <u>239.1</u> | <u>290.9</u> | 51.8 | 21.7% |
| *1 | | | | |
| Import/Export Service Charges | 630.7 | 809.7 | 179.0 | 28.4% |
| Ground Rent | 496.8 | 605.8 | 109.0 | 21.9% |
| Net Income from Supply of Water | 244.3 | 334.6 | 90.4 | 37.0% |
| Annual Fees | 481.4 | 543.7 | 62.3 | 13.0% |
| Rent Income | 64.7 | 113.6 | 48.9 | 75.5% |
| Land Premium | 51.2 | 60.8 | 9.6 | 18.8% |
| Other | 257.4 | 253.7 | (3.7) | -1.4% |
| | <u>2,226.4</u> | <u>2,721.8</u> | | |
| *2 | | | | |
| Administrative Expenses | 1,779.9 | 1,983.9 | 204.0 | 11.5% |
| Operating Expenses | 230.1 | 337.0 | 107.0 | 46.5% |
| Government Levies | 47.8 | 148.1 | 100.3 | 209.8% |
| Other Expenses | 30.9 | 24.3 | (6.6) | -21.5% |
| | <u>2,088.7</u> | <u>2,493.3</u> | | |

Source: Survey team based on Annual Report 2013, Board of Investment¹³

The main income sources of the BOI include fixed-amount commissions for assisting export and import procedures from EPZs, ground rent, annual management fees from BOI companies, rent from EPZ tenants and commissions for issuing licenses for BOI companies. For expenses, operating expenses, administrative expenses such as salaries for personnel (covering over 50% of the administrative expenses) and staff welfare expenses (about 10% of the administrative expenses) are major expenditures.

The BOI is regarded as the sole organization that grants BOI status to companies that directly invest in Sri Lanka, and satisfy requirements in Articles 16 and 17 of the BOI Act. The requirements of the two articles of the act are provided in section 3.3.3.

¹³ Figures from the Annual Report has been adopted, therefore audit differences by the Board of Audit has not been edited.

The BOI established the One-Stop Shop (OSS) in February 2016 to offer one-stop services as the investment promotion agency. The OSS issues a guide for laws and regulations necessary for examining investments in Sri Lanka and application forms. It also offers information on procedures, while also consulting with individual investors on a series of processes from accepting and checking applications, to promoting relevant ministries for investors to acquire investment permits until the start of commercial activities. The number of inquiries and applications the OSS received from January to May 2017 is provided in the table below. Although number of inquiries and approval are constant, there is no indication for significant inquiries on specific month. With respect to the tourism industry, the Sri Lanka Tourism Development Authority offers its own one stop shop services by establishing the One Stop Unit.

Table 3-2 Number of Inquiries to the One Stop Shop (Jan – May 2017)

| | January | February | March | April | May |
|----------------------|---------|----------|-------|-------|-----|
| Inquiries | 24 | 16 | 26 | 19 | 25 |
| Approved Application | 4 | 4 | 8 | 0 | 1 |

Source: Survey team based on interviews to BOI

To accelerate issuance of investment permits, two commissions was set up. The Single Window Investment Approval Committee (SWIAC) is comprised of six senior officials including the director general of BOI, and is chaired by the vice minister of the MOF. It was established as an organization outside the BOI to assess approval of large scale investments and projects with high added values in early 2017. This Committee meets around every three months, but the actual results are not disclosed. The Investment Appraisal Facility Committee (IAFC) consists of four senior officials and is chaired by the senior adviser to the Prime Minister’s Office. It was set up in April 2016 as a council that promptly solves issues investors face in the process of acquiring a permit from line ministries and starting operation. The Implementation Department within the BOI serves as the secretariat to arrange a meeting once a month or so, set up the agenda, prepare the meeting minutes, and provide follow-up for resolving issues. Currently, the IAFC has held 17 meetings since its establishment, working to resolve 26 issues.

There is no specific act that clearly states the establishment of either of these organizations. However, the Prime Minister’s address on economic policy in October 2016 refers to the former and indicates its establishment (quote from the original statement follows).

“Additionally, the Government will also prepare legislations to **establish a single window for investment approval**” (boldfaced and underlined by the Survey team.)

It is considered that Cabinet Committee on Economic Management had appointed Investment Approval Facilitation Committee (IAFC) and Investment Single Window Committee (SWIAC) by letter dated 1952016 issued by the Secretary to the Prime Minister in response to this statement.

For the purposes of developing the investment promotion policy and providing information to investors, the BOI collects data and information concerning foreign direct investment and it plays the role of the first contact point for potential investors to consider investment in Sri Lanka. It uses a website¹⁴ and brochures as the major media for basic information provision activity to attract investments. The website content is available in nine languages and the top page summarizes the attractiveness of Sri Lanka, methods to start a business in Sri Lanka, details of services offered by the BOI and outline of the EPZ and industrial parks. Further details include the Investment Guide (English, Chinese, Japanese), which explains specific method to set up business as well as market overview and attractiveness as investment destination for five sectors (IT, manufacturing industry, hub function, tourism, knowledge service), thereby enabling exposure to basic information necessary for considering investment. Also, contact email addresses and telephone numbers can be found on the website so that potential investors can directly contact them for consultation. The information provided through these media covers minimum required information, such as general information on society and economy, investment application, approval procedures necessary to start and operate business and legal information concerning investment and as such, investors can collect useful information from the materials distributed by the BOI. Fundamental statutes on investment and necessary application forms are also available on the BOI website, clarifying the procedures that investors are required to fulfil. However, there are some out dated information still published on the website. Issues related to information on out dated regulations on the BOI website will be explained in 3.3.3.

Specific PR activities implemented by the BOI consist of activities to unearth investment projects by commercial officers of overseas embassies and activities through cooperative relationships with relevant ministries of Sri Lanka, foreign embassies in Sri Lanka and economic and commercial organizations. While overseas missions are dispatched mainly to emerging countries to promote attractiveness of Sri Lanka, acceptance of foreign delegates are mostly from countries with the record of FDI, which are highly likely to provide opportunities to identify specific investment projects (such as European countries, Japan and China). For Japan, Korea and China, dedicated personnel have been appointed to respond inquiries. For example, in order to approach Japanese companies, a Desk Officer for Japan is appointed within the BOI and by concluding an MOU with Bank of Tokyo-Mitsubishi UFJ and Mizuho Bank, cooperative relationships with Japanese companies are being developed. Major activity records of missions dispatched and hosted by the BOI in 2013 are as follows.

¹⁴ <http://www.investsrilanka.com/>

Table 3-3 International Investment Missions Dispatched and Hosted by BOI

| Outward missions | Period | Purpose for the visit |
|------------------------|--------------------|---|
| Germany | 2013. Feb to March | Investment promotion mission |
| Singapore and Malaysia | 2013. May | Investment promotion mission, Business meetings |
| India | 2013. May | Presentation for selected business community in India |
| Czech Republic | 2013. March | Investment promotion mission |
| Japan | 2013. March | Participation at investment promotion event |
| Korea | 2013. May | Participation at investment promotion event |
| UAE | 2013. June | Ministerial delegation, Participation at investment promotion event, Business meetings |
| Australia | 2013. June | Investment promotion event |
| China | 2013. June | Participation at investment promotion event |
| Thailand | 2013. July | Awareness programmed for Commonwealth Business Forum |
| Turkey | 2013. Aug to Sept | Ministerial delegation, Investment Promotion mission, Participation at an international fair |
| Indonesia | 2013. November | Annual Forum of Developing Country Investment Negotiators |
| Malaysia | 2013. November | Investment promotion mission |
| Inward missions | Period | Area of interest by investors |
| China | 2013. January | Power Plant |
| Germany | 2013. February | Manufacturing |
| Estonia | 2013. February | Manufacturing, Warehousing, logistics, IT |
| Japan | 2013. February | Cosmetics |
| Abu Dhabi, UAE | 2013. March | Tourism, Petroleum |
| Qatar | 2013. March | Tourism, Leisure |
| China | 2013. March | Tourism, Real Estate Development |
| China | 2013. March | Manufacture of air conditioners, Real estate development |
| China | 2013. March | Exploring mineral sands |
| China | 2013. April | Airport development, Manufacturing(Steel industry), Tourism, Real estate development |
| China | 2013. April | Real estate development, Tourism |
| Belgium | 2013. May | Infrastructure, Manufacturing, Tourism |
| China | 2013. May | Apparel |
| China | 2013. May | Apparel |
| China | 2013. May | Semiconductor manufacturing |
| Abu Dhabi, UAE | 2013. June | Travel, Tourism |
| Japan | 2013. June | Infrastructure |
| Japan | 2013. July | Pharmaceuticals |
| Japan | 2013. July | Infrastructure |
| China | 2013. July | Manufacturing industrial elevators |
| Ivory Coast, India | 2013. August | Joint ventures with potential investors |
| Japan | 2013. August | Infrastructure, Renewable energy |
| Singapore | 2013. September | Hospitality and infrastructure sectors |
| Netherlands | 2013. September | Agriculture, Manufacturing of Jewellery, Power & energy |
| France | 2013. September | Infrastructure, Manufacturing, Tourism |
| Oman | 2013. October | Food Processing |
| Japan | 2013. October | Infrastructure, Manufacturing, electronic items, Auto parts, Cosmetics, Pharmaceuticals, Food processing, Tourism |
| China | 2013. October | Construction, Hotels, Fisheries Industry, Mining and Rubber products |
| Malaysia | 2013. November | Tourism, Leisure, Infrastructure |
| China | 2013. November | Fisheries |
| Switzerland | 2013. November | Manufacturing |
| China | 2013. November | Shrimp farming, Feed manufacturing |

Source: Survey team, based on Annual Report 2013, Board of Investment

At the BOI, as a centralized point of contact for investors considering business development in Sri Lanka, the OSS consults with individual investors and specialized staff are appointed to provide information on necessary procedures, requirements, incentives among others. There is no department dedicated to aftercare support to facilitate investment expansion and such support is currently provided through daily communication by the Appraisal Department, Monitoring Department or managers of the EPZ.

Procedures from the registration and application to the conclusion of agreement and business commencement are under the responsibility of the Appraisal Department and after the conclusion of agreement, the Implementation Department takes over and provides support to investors until the start of business. After commencement of commercial activities, investors are supported by the Monitoring Department. To assist investors in preparing for start of operations, specialized staff is appointed for each of the five sectors (① Public works and services; ② Travel and tourism, agriculture, knowledge service; ③ Infrastructure; ④ Apparel; ⑤ Manufacturing industry other than apparel).

Investors contemplating advancement are provided with useful information for decision-making and are supported in conducting feasibility study by the OSS or Media & Publicity department.

For investors who have made the decision to set up business, the Appraisal Department and the Implementation Department provide services to enable them to smoothly operate the business. These services include technical consulting to incorporate business, acquisition of licenses and land from relevant ministries, acting as a contact point for importing and exporting, facilitation service for visa acquisition and renewal, and support to resolution of issues in practical business.

With respect to companies that have started commercial activities, the Monitoring Department verifies the finance and investment plan of each company. Specifically, the amount of investment, number of employees, scale of import and export are checked to make sure that they conform to the agreement with the BOI and when an application is made for visa extension and business expansion, the application is examined to check the validity.

3.1.4 Export Development Board

EDB was established in 1979 based on Sri Lanka Export Development Act No. 40 for export expansion of Sri Lankan goods. The EDB was set up as the working body of the Export Development Council of Ministers chaired by the President and it is to assist Sri Lankan companies to expand opportunities of selling their goods in overseas markets.

Article 12 in Part III of the Export Development Act specifies functions and roles of the EDB. The roles can be summarized as the expansion of opportunities to export Sri Lankan goods through the following activities.

- Formulating and implementing the National Export Development Plan and sectoral development plans, in association with the relevant state and private sector agencies.
- Formulating and implementing the National Export Development Plan and sectoral development plans, in association with the relevant state and private sector agencies.
- Providing exporters with a viable overseas market-environment by active participation in trade negotiations and relevant follow-up activities.
- Conducting market research/surveys and identifying market opportunities for Sri Lankan products and services.
- Implementation of supply development programmes including technical, quality and packaging development, in order to assist exporters/potential exporters to improve/increase the competitiveness of exports.

- Providing up to date information on markets, products, tariffs, regulations, international commodity prices, and national/international trade statistics.
- Working with international trade promotion organizations as well as other local trade support organizations, with the purpose of assisting exporters and potential exporters in the development of business opportunities in the world market.

EDB employees provide consulting services for companies in Sri Lanka to expand their export opportunities and organize seminars as co-sponsors with companies to increase the opportunities also from other regions than Colombo and its surrounding areas.

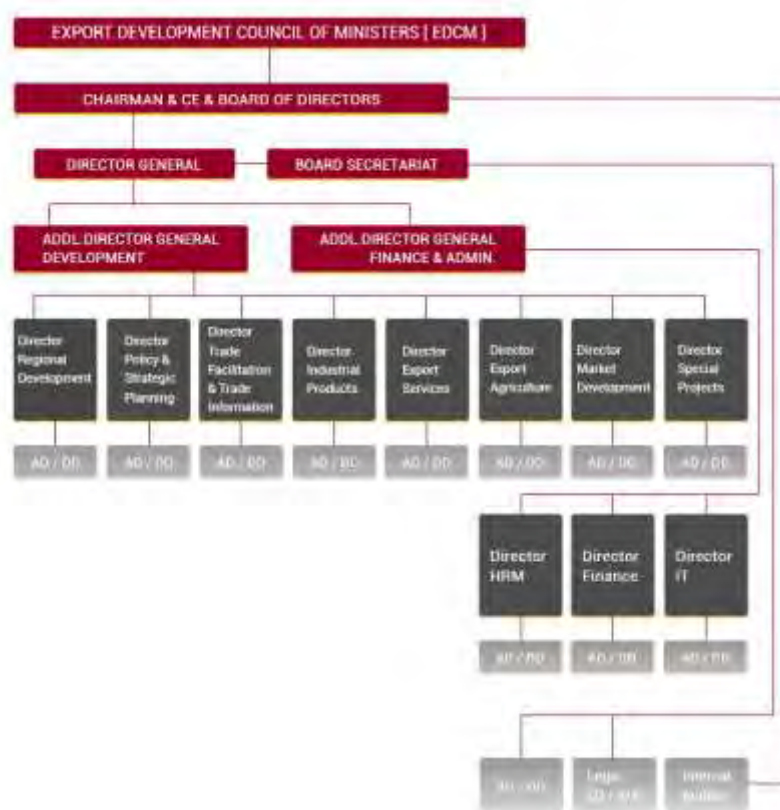


Figure 3-3 Organizational Structure of EDB

Source: EDB website

The non-disclosed action plan has following three goals to be achieved through its activities.

- Expand export to USD 20 billion by 2030 (USD 17.7 billion in 2016)
- Increase 100,000 labour of youth in export industries by 2030
- Increase 2,000 additional exporting companies by 2020 from current 3,800

The following action goals listed on EDB website are believed to be the precursor of the action plan.

- To increase the country's export value of products and services to USD 15 Bn. by 2015. (USD 20 Bn. by 2020)¹⁵
- To increase exports to markets other than the EU and USA by over 50% by 2015, (2020) while consolidating the market position in the EU and USA.¹⁶
- To pay particular attention to the seven identified key product sectors¹⁷, which will contribute over 80% of total export value, and achieve significant growth in those sectors.
- To project a more positive and a favourable image of Sri Lanka's exports as a whole, through the conduct of integrated marketing communication programmes in selected markets.
- To broad-base the beneficiaries of exports across the country and sectors, including SMEs.
- To build a team of excellence at the EDB, based on core values, with particular emphasis on employee productivity and commitment.

3.2 Investment-related laws

Sri Lankan laws related to foreign investment are summarized below.

3.2.1 Board of Investment Act

The Board of Investment Act 1978 stipulates the legal framework of FDI into Sri Lanka. Comprising of 35 articles, the act was originally to support the Greater Colombo Economic Development Commission (GCEC) that was organized to promote economy of Colombo and its surrounding areas. The GCEC was reorganized as the BOI to serve the entire country in 1992.

The BOI Act consists of following articles.

| | |
|-------------------|---|
| Articles 1 to 3 | Purpose of establishment, etc. |
| Articles 4 to 14 | Scope of jurisdiction and organization of BOI, etc. |
| Articles 15 to 29 | Power over investors and conditions for its execution, etc. |
| Articles 30 to 35 | Operation of BOI, etc. |

Important articles in the BOI Act for investors are Article 16 (General power of the Commission) and Article 17 (Power of the Commission in relation to any agreement with any enterprise). Investors apply for approval from the BOI to receive tax incentives or special treatment for visa acquisition based on the two articles. The following is an excerpt of the relevant text.

¹⁵ Amount of Export of goods and service in 2015 and 2016 are US\$ 10.01 Bill and US\$ 10.48 respectively. (Source: Key Indicators for Asia and the Pacific 2016, ADB)

¹⁶ Top 10 export destination of Sri Lanka consist 62% of entire export value. Within top 10 Non WE and Non EU nations are India, UAE and Japan which equals 19.56% of export amount. (Source: Key Indicator of Asia and the Pacific 2016, ADB)

¹⁷ By ratio of export: Apparel, Ceylon Tea, Rubber Products, Coconut, Electrical & Electronics, Spice, Food & Beverage (Source from EDB website, statistics on export performance 2016).

Article 16 Without prejudice to the generality of the powers conferred on the Commission by this Law, the Commission shall have the power to

- to do all such acts or taken such steps as may be necessary or conducive to the attainment of the objects of the Commission;
- to acquire, sell or lease land for the purposes of industrial sites, for the use of employees or for general economic development;
- to lay out industrial estates for sale or lease;
- to enter into agreements with enterprises
- to exercise, perform and discharge all such powers, duties and functions as are by or under this Law vested in or assigned or delegated to the Commission; and
- generally, to do all such other acts and things as are incidental to or consequential upon the exercise, performance and discharge of its powers, duties and functions under this Law

Article 17 (1) The BOI shall have the power to enter into agreements with any enterprise in or outside the area of its authority in order to conduct any business approved by the minister and to grant exemptions from any law referred to in Schedule B.

Laws in Schedule B where applications are to be exempted are listed below.

- The Inland Revenue Act #4, 1963
- The Customs Ordinance Chapter 235
- The Exchange Control Act, Chapter 423
- The Companies Ordinance, Chapter 145
- Merchant Shipping Act #52, 1971
- Finance Act #65, 1961
- Air Navigation Act

In 2011, the amended Inland Revenue Act (IRA) was enforced, giving superiority of tax exemption from the BOI Act to the IRA. Additionally the Budget Speech 2016 by the Finance Minister in 2015 stated the suspension of granting tax exemption under the amended IRA.

3.2.2 Companies Act

A company is established in accordance with the Companies Act No.7 of 2007 in Sri Lanka. It consists of 23 chapters and 534 articles.

The Companies Act stipulates that investors are to be treated equally regardless of their nationality. Incorporated companies are largely classified into unlimited and limited liability companies and it also stipulates the branch and representative offices as non-incorporated business forms. Other forms of office also include project offices and off-shore companies.

(1) Company liquidation

The Companies Act No.7 of 2007 provides three types of company liquidation (withdrawal)—voluntary liquidation by the shareholders, liquidation by court decision and voluntary liquidation under court supervision.

Following is the summarized reasons for voluntary liquidation by shareholders and the procedures.

- When reasons for company dissolution are specified in articles of incorporation and they occur resulting in voluntary dissolution decided in a shareholders' meeting;
- When voluntary dissolution is decided in an extraordinary resolution; or
- When continuing business is difficult due to liabilities and dissolution is preferred as a result of an extraordinary resolution through a shareholders' meeting.

Table 3-4 Winding up Process in Sri Lanka¹⁸

| Steps | Contents |
|--|---|
| Preparation of affidavit | Affidavit of all or over half of the board of directors is prepared, based on detailed credit investigation and consolidation of debts will be completed within a year of start of liquidation process. |
| Decision on winding up and appointment of liquidator | After having special resolution from the shareholders meeting, a liquidator is appointed to organize residual assets. |
| Announcement of dissolution of company | Announcement of liquidation resolution (Form 39) submitted within 10 working days, appointment of liquidator notification (Form 26B) submitted within 2 weeks to the ROC, result of approval publicly announced. |
| Conduct of dissolution | As soon as the liquidation process is complete, the liquidator shall call a general meeting, the board approval of completion of liquidation announced. Completion of liquidation (Form 29A) and confirmation of residual assets and report on distribution of residual assets (Form 27) submitted to the ROC within one week of the board meeting. Company is considered liquidized 3 months from this submission. |

Source: Survey team based on Companies Act 2007

3.2.3 Dispute settlement

Settlement of commercial disputes is stipulated in the Arbitration Act No.11 of 1995. The arbitration act provides an outline of commercial arbitration in accordance with regulations on arbitration procedures under the UNICITRAL (United Nations Commission on International Trade Law) that is an UN standing committee.

Three commercial arbitration courts are operating in Sri Lanka. However, the number of arbitrators or facilities to conduct the arbitration court activities are insufficient and they need to be improved. The following arbitration courts are currently in service.

¹⁸ For details of company liquidation, refer to Part XII of the Companies Act

- Sri Lanka National Arbitration Centre (SLNAC)
- Institute for the Development of Commercial Law and Practices (ILCP)
- Colombo International Arbitration Centre (CIAC)

3.2.4 Foreign exchange law and laws related to capital flows

(1) Overview of foreign exchange law

Foreign exchange is regulated by the Exchange Control Act No. 24 of 1953 in Sri Lanka and it is supervised by the Exchange Control Department. Separately from the current act, a bill to promote and regulate foreign exchange has been submitted to Parliament. It is uncertain whether the bill will become a law in the near future as it is now.

Permission for foreign currency transfer and acceptance is not necessary for exports. Exporters can send export payment to a Rupee account or an Exporters' Foreign Currency Account (EFCA) belonging to a commercial bank in Sri Lanka. The foreign exchange law does not set any limitations on companies established in Sri Lanka holding shares of foreign companies involved in commodities exports.

Gazette Notification No. 1960/66 dated April 1, 2016, stipulates that compensation for goods exported from Sri Lanka be paid to the country within 90 days from the date of exportation. On the other hand, the terms of payment for imported goods are provided in Gazette Extraordinary No. 1739/6 dated 02nd January 2012 (under the Import and Export (Control) Act No. 01 of 1969).

Controllers of the Department of Import and Export have the power to stipulate the law. Terms of payment approved regarding commercial imports are described below.

D/P: Document against Payment

D/A: Document against acceptance

L/C: Letter of Credit

Advance Payment (Cash-in-Advance)

Consignment Account basis

Open Account basis¹⁹

Limitations on the payable amount as an advance payment and the duration in which the payment can be made after the import of goods in Sri Lanka are specified.

¹⁹ Overview of each terms of payment:

D/P: The importer to pay the fee to the bank, and the bank will publish a Shipping Document in return for collection of the cargo.

D/A: Importer to pledge the documentary bill to the bank, and receive a Shipping Document in return for collection of the cargo.

L/C: Confirmation document from the bank to guarantee the payment.

Advance Payment: To pay the fee before receiving cargo

Consignment Account basis: Payment for consigned sales/ exporting.

Open Account basis: Cargo is shipped before the payment due.

(2) Capital transaction and investment by non-resident

Major regulations on investment from outside of Sri Lanka, including the following, are stipulated in the foreign exchange law, etc.

Government securities:

Government securities include state bonds and short-term government bonds. However, the investment shall not exceed 12.5% of the total amount of the two types of bonds issued.

Corporate bonds:

Investment in corporate bonds of listed and unlisted companies is permitted only through an SIA²⁰.

Investment in investment trusts:

Investment in investment trusts by non-residents can be 100% of the unit. However, investments can be made via an SIA of LCB.

Real estate:

Foreign investment in real estate is permitted based on foreign exchange control. However, the Land (Restrictions on Alienation) Act No.38 of 2014 prohibits transfer of land to companies established under the Sri Lankan Companies Act and more than 50% of their shares are owned by foreigners directly or indirectly or foreign companies. Thus, when land is transferred to Sri Lankan companies with less than 50% of their shares owned by foreigners, they need to continue to own less than 50% of their shares for 20 years in continuation from the date of transfer. As the law became effective on January 1, 2013, it is deemed applicable from this date on. When direct or indirect share ownership exceeds 50%, land transfer becomes invalid.

Any form of investment above is permitted as long as the funds are brought in legitimately. Investors in Sri Lanka are required to make investments via an SIA that is opened by LCB.

(3) Loans from abroad

Loans can be received from outside of Sri Lanka under foreign exchange control regulations. Foreign loans based on the external borrowing scheme is permitted in accordance with Gazette Notification issued on June 7, 2016. Under the scheme, no special permit from the Controller of Exchange is required to receive loans from outside Sri Lanka. The regulations provide the following.

- The tenure of loans shall be at least 3 years.
- The maximum amount of borrowing shall be based on the financial soundness of the company

²⁰ SIA is stipulated with respect to the account and eligible investment sector for investment by foreigners on the basis of Gazette Notification No. 1232/14 of 19.04.2002, which supplements the Exchange Control Act 1953. Currently, Exchange Control Direction to Authorized Dealers No. 06/04/18/2013 of 12.06.2013 is proclaimed to determine the enforcement regulations for operation.

to repay the loan based on its audited financial statements for at least the most recent three years and the business plan.

- The rate of interest shall be competitive and favourable when compared with the prevailing market rates in Sri Lanka.
- All proceeds and the repayments of the borrowing shall be routed through an External Commercial Borrowing Account maintained by the borrower in any designated foreign currency in a licensed commercial bank in Sri Lanka.

(4) Money transfers overseas

Accounts from which money can be transferred from Sri Lanka include Non-Resident Foreign Currency Accounts (NRFC), Resident Foreign Currency (RFC), Resident Non National Foreign Currency Account (RNNFC), Foreign Exchange Earners Accounts (FEEA), Outward Investment Account (OIA) and SIA used accordingly²¹.

3.2.5 Tax laws

(1) Inland Revenue Act (IRA) and corporate tax

The corporate tax is imposed in accordance with the Inland Revenue Act (IRA, act No. 10 of 2006, has been amended 8 times) based on the principle of residency. The tax is imposed on all global profits and income²² for residents, whilst a non-resident is taxed on his/her income and profits arising in or delivered from Sri Lanka.

Residency and taxation

Corporate tax in Sri Lanka is determined based on the corporate structure. (For example, limited liability companies incorporated in the country are regarded as resident in taxation terms, whilst an overseas office where management and control is not carried out by Sri Lankan corporation, is regarded as a non-resident)

Japanese companies may be exposed to taxation in Sri Lanka based on the provisions of the Double Tax Avoidance Treaty (DTA) between Sri Lanka and Japan, even if it is not registered in Sri Lanka.

As per the DTA, a resident of Japan will be liable for tax on industrial and commercial profits in Sri Lanka if business is carried out through a Permanent Establishment (PE) in Sri Lanka. Tax is on the profits but only so much as is attributable to the PE (Article 3 of the DTA).

Taxation threshold and tax rate

There is no taxation threshold of the corporate tax for its exemption when the taxable income is below

²¹ Overview of each account as followed:

NRFC: Foreign currency account held by Sri Lankan nationals residing abroad, to promote foreign currency remittance.

RFC: Foreign currency account held by Sri Lankan nationals residing inside Sri Lanka

RNNFC: Foreign currency account held by non-Sri Lankan nationals residing in Sri Lanka

FEEA: Account for residents receiving foreign currency through foreign exchange transaction

OIA: Account for residents in Sri Lanka to invest in foreign stock or government bond

²² Global profits and income means taxable income regardless of where residents earn from domestic and foreign sources.

a certain amount. The standard tax rate is 28% of taxable income.

The IRA applies a special tax rate in special cases. When certain conditions are met, permission for payment relief or tax exemption may be applied.

Please refer to attachment 1.2 about calculation and payment of corporate tax, filing the income tax return, penalties for taxes in default and non-compliance, assessments and appeals.

(2) Value Added Tax (VAT) Act

The VAT was introduced under the VAT Act (Act No. 14 of 2002). The Goods and Services Tax (GST) was replaced with the VAT. The VAT Act has been amended 13 times since its enactment as of August 2017.

VAT liability

The VAT is levied on goods and services provided in Sri Lanka. It is also imposed on imported goods.

In other words, it is imposed on all taxable activities of sales of taxable goods and services in Sri Lanka conducted by registered entities during the taxation period.

The taxable activities are defined under the VAT Act and they include business, trade, expertise and professional activities excluding labour cost or speculation. Thus, trading and business activities in Sri Lanka are taxable activities.

The VAT is also invoiced on imports and it is collected when goods are imported at the customs.

Liability Threshold

In order for a person to register for VAT, such person must have taxable supplies (excluding exempt supplies) to the value of 3Mn LKR per quarter or 12Mn LKR for a period of 12 months. However, where the output is exempt from VAT, there is no requirement to register.

Rate of Tax

The VAT Act has two rates; 15% and 0%. VAT is charged at a standard rate of 15% on the value of supply. Section 7 of the VAT Act lists down the supplies that are zero rated. (E.g. exports).

Please refer to attachment 1.3 about calculation and payment of VAT, time of supply, filing the return, and penalties for taxes in default and non-compliance.

(3) Nation Building Tax (NBT) Act

The NBT is imposed based on the NBT Act (act No. 9 of 2009 and it has been amended seven times as of August 2017).

NBT Liability

The NBT Act states that the NBT will apply on:

- every person who imports of any article,
- every carrier on the business of manufacture of any article,

- every carrier on the business of providing a service of any description, or
- every carrier on the business of wholesale and retail trade

Liability Threshold

NBT is imposed as above only if the liable turnover for a quarter exceeds 3 Million LKR.

Rate of NBT

2% on the liable turnover (other than any turnover from the wholesale or retail sale) of any article. Liable turnover from wholesale or retail sale of any article

- 0% (Nil) on 3/4 of the liable turnover of any distributor, and 2% of the 1/4 of the liable turnover
- 0% (Nil) on 1/2 the liable turnover of any article (other than any distributor), and 2% on the 1/2 of the liable turnover.

Please refer to attachment 1.4 about calculation and payment of corporate tax, filing the income tax return, penalties for taxes in default and non-compliance, assessments and appeals.

(4) Economic Service Charge (ESC) Act

The ESC is imposed in accordance with the ESC Act (act No. 13 of 2006, has been amended eight times as of August 2017).

ESC can be set off against the income tax liability, within 3 years. Therefore, to such extent, ESC serves as advance payment of the corporate tax. Where a company is enjoying a tax holiday, the ESC paid may be a cost since there is no income tax liability to offset the ESC payment.

ESC liability

The ESC is imposed on the entire taxable sales of all persons (including individuals, companies, organizations and partnerships).

Liability Threshold

A liability to pay ESC for any quarter arises only if the relevant turnover for that quarter exceeds 12.5 Million LKR.

Rate of Tax

The rate for ESC is 0.5% of relevant turnover.

Please refer to the attachments about payment of ESC, filing the return, and penalties for taxes in default and non-compliance.

(5) International taxation

Sri Lanka is a signatory country of the South Asian Association for Regional Cooperation (SAARC) and has signed 42 bilateral double tax avoidance treaties. Thus, the international taxation depends on the existence of relevant double taxation agreements (DTAs). For example, Sri Lanka and Japan have a double taxation agreement to deduct the amount of tax that is paid in the territory of the other country. There are various provisions on dividends, royalties and residency conditions.

Additionally, the Government of Sri Lanka introduced a provision that requires taxpayers with international transactions of over 100 million LKR with relevant business entities to submit a transfer price disclosure form together with the corporate tax report in 2015. It requires a certificate by a chartered accountant and the form needs to include disclosure that the taxpayer needs to comply with rules of the transfer prices of Sri Lanka and prepare necessary documents related to transfer prices. The Transfer Pricing Regulations Unit (TPRU) of the IRD supervises both taxpayers that purely conduct domestic transactions and those that conduct domestic and international transactions.

(6) Taxation revision in FY2017

The budget speech disclosed in November annually by the Finance Minister indicates the course of taxation revision from April of the following year, to March of the year immediately after the year. Tax amendment bills are deliberated by the Parliament in accordance with the budget speech.

The following is the summary of major changes that affect both foreign and local companies indicated in the latest budget speech 2017 (published November 2015).

- Change of corporate tax rate: As part of the simplification effort of the Corporate Tax Act, three tax rates of 14%, 28% and 40% will be applied from April 2017. The tax rate will be raised from the previous rate (28%) for some companies.
- Abolition of SVAT (Simplified VAT) scheme: The 2017 budget speech announced that the SVAT scheme that was decided to be introduced in 2011 to shorten and simplify the process of VAT return will be abolished. However, its abolishment is postponed by a notice to taxpayers issued by IRD on April 12, 2017²³.

(7) Strategic Development Project Act

The Strategic Development Projects Act, No. 14 OF 2008 aims to promote developments of certain projects identified, through discussion with line ministries to the BOI. Certain projects are identified as projects that come under the following conditions;

- the strategic importance attached to the proposed provision of goods and services, which will be of benefit to the public;
- the substantial inflow of foreign exchange to the country;
- the substantial employment which will be generated and the enhancement of the income earning opportunities; and
- the envisaged transformation in terms of technology.

²³ See 3.5.2 in detail.

Projects approved will be called SDP projects, eligible to receive preferential treatments on the following regulations;

- Inland Revenue Act
- VAT Act
- The Finance Act, No. 11 of 2002
- The Finance Act, No. 5 of 2005
- The Excise (Special Provision) Act, No. 13 of 1989
- ESC Act
- Customs Act
- NBT Act
- Ports and Airports Development Levy Act
- Sri Lanka Export Development Act (No. 40 of 1979)
- Betting and Gaming Levy Act No. 40 of 1988

The discarding of the Strategic Development Project Act was planned for congress approval, but hasn't been submitted to the congress as of August 2017. However no SPD approval has been given to any project since January 2016.

3.2.6 Customs Ordinance, Introduction and Implementation of the WTO Agreement

(1) Customs Ordinance

With the introduction of the Customs Ordinance (act No. 17 of 1869), Sri Lanka Customs developed into a full-pledged state organization mainly responsible for the collection of revenue and the enforcement of law.

The Customs Ordinance consists of 14 parts listed below and some schedules.

- Part I Management
- Part II Levying of Customs Duties
- Part III Port Dues
- Part IV Regulations Inwards
- Part V Entry of Goods Reimported
- Part VI Removal of Goods by Sea or Inland Carriage
- Part VII Regulations Outwards
- Part VII Trade by Vessels of less than 15 tons Burthen
- Part IX Regulations Coastwise
- Part X Regulation of Movements of Ships under 250 tons
- Part XI Warehousing of Goods
- Part XII General Regulations
- Part XIII Smuggling, Seizures and Prosecutions Generally
- Part XIV Interpretation of Terms Used in This Ordinance

Status of introduction and implementation of the WTO agreement

Sri Lanka started preparation to ratification of the WTO Agreement on Trade Facilitation ("WTO agreement") in 2014 with the support of the World Bank.

The main contents of the WTO agreement is as follows²⁴:

- ✓ Measures to enhance transparency of trade regulations
 - Disclosure of trade procedures on the internet
 - Introduction of advance ruling (such as an issue of a decision on HS code before import of goods)
- ✓ Measures for rapid release and clearance of goods and simplifying documentation requirements
 - Application of expedited shipments in advance of the arrival of goods and introduction of risk management system for customs control
 - Establishment of a single window enabling traders to submit documentation and/or data requirements for importation, exportation, or transit of goods

Developed countries were requested to implement all of the provisions at the time of enforcement²⁵ of the WTO agreement. On the other hand, developing countries were able to have a transition period which they will be assisted for capacity building to implement the provision of the WTO agreement.

The World Bank provides countries with the following products and services in its trade facilitation support program.

- Knowledge products (reports, articles etc)
- Diagnostics and implementation support tools
- Technical assistance and advisory services
- Financing for major trade and transport facilitation and institutional reform projects (software and hardware)
- Research and data products (LPI/Doing Business)
- Global advocacy and partnerships with key regional and international organizations

Sri Lanka and the World Bank classifies each article of the WTO agreement into the following three categories based on difficulty of introduction and due date of implementation as stated in the WTO Agreement.

- Category A: Countries wanting to improve upon existing functional practices to align with best practice.
- Category B: Self implementation efforts exist but require support.
- Category C: Technical assistance is clearly required and requested by member countries.

²⁴ The content of this paragraph is based on information in the web site of the Japanese MOF and the WTO agreement.

²⁵ The WTO General Council on November 27, 2014 adopted the amendment to introduce articles of the WTO trade facilitation agreement.

Planned date of implementation for category B is required to be submitted to the national committee on trade facilitation no later than a year after the entry of the WTO agreement (WTO agreement Article 16, Paragraph 1). If in case submission is delayed, approval from the national committee on trade facilitation is required of the duration of delay.

On the other hand, for category C, each country member and donor will clarify on the existing agreement documents within a year of entry. Within 18 months of receiving relevant information from donors, a list of planned dates for implementation of each article in category C, and progress on supports capacity building needs to be submitted to the national committee on trade facilitation.

Sri Lanka submitted its Category A commitments on July 31, 2014, and entered into force on February 22, 2017. Sri Lanka is expected to submit Category B and C commitments soon, but not yet as of August 2017.

Each article of the WTO agreement is classified as the following tables in Sri Lanka.

Table 3-5 Category A commitments in Sri Lanka

| Article | Title |
|-----------|---|
| 4.1 | Right to Appeal or Review |
| 5.2 | Detention |
| 6.3 | Penalty Disciplines |
| 7.2 | Electric Payments |
| 7.8 | Expedite Shipments |
| 9 | Movement of Goods under Customs Control intended for Import |
| 10.6 | Use of Customs Brokers |
| 10.7 | Common Border Procedures and Uniform Documentation Requirements |
| 10.8 | Rejected Goods |
| 10.9 | Temporary Admission of Goods/Inward and Outward Processing |
| 11.1-3 | Transit Charges, Regulations, and Formalities |
| 11.4 | Transit Strengthened Non-Discrimination |
| 11.5-10 | Transit Procedures |
| 11.11.1-5 | Transit Guarantees |
| 11.12-13 | Transit Cooperation and Coordination |

Source: Sri Lanka Customs

Table 3-6 Category B commitments in Sri Lanka

| Article | Title |
|---------|--|
| 7.1 | Pre-arrival Processing |
| 10.5 | Pre-shipment Inspection |
| 23.2 | National Committee on Trade Facilitation |

Source: Sri Lanka Customs

Table 3-7 Category Commitments in Sri Lanka

| Article | Title |
|---------|---|
| 1.1 | Publication |
| 1.2 | Information Available Through Internet |
| 1.3 | Enquiry Points |
| 1.4 | Notification |
| 2.1 | Opportunity to Comment and Information before Entry into Force |
| 2.2 | Consultations |
| 3.1 | Advance Rulings |
| 5.1 | Notifications for enhanced controls or inspections |
| 5.3 | Test Procedures |
| 6.1 | General Disciplines on Fees and Charges Imposed on or in Connection with Importation and Exportation |
| 6.2 | Specific Disciplines on Fees and Charges Imposed on or in Connection with Importation and Exportation |
| 7.3 | Separation of Release from Final Determination of Customs Duties, Taxes, Fees and Charges |
| 7.4 | Risk Management |
| 7.5 | Post-Clearance Audit |
| 7.6 | Establishment and Publication of Average Release Times |
| 7.7 | Trade Facilitation Measures for Authorized Operators |
| 7.9 | Perishable Goods |
| 8 | Border Agency Cooperation |
| 10.1 | Formalities and Documentation Requirements |
| 10.2 | Acceptance of Copies |
| 10.3 | Use of International Standards |
| 10.4 | Single Window |
| 12 | Customs cooperation |

Source: Sri Lanka Customs

Sri Lanka has already introduced the articles in category A on 22 February, 2017. However, in order to introduce the articles in category B and category C, registration of a New Customs Ordinance is necessary. The New Customs Ordinance was still at its drafting stage, and has no clear prospect on when it will be submitted to the cabinet. On the other hand, some functions stated in the WTO agreement has already been customarily performed in Sri Lanka.

3.2.7 Legal issues

(1) Legal issues

① BOI Act

The current granting of tax incentives for investors approved under Article 17 of the BOI Act have been abolished with the enactment of IRA 2011. Additionally, the same granting of tax incentive stated in the IRA 2011 had been suspended by the Budget Speech 2016, given on November 2015. It is because the Inland Revenue Act is currently amended with assistance from the IMF. As a result of the amendment, the tax exemption period is likely to be abolished while the requirement of minimum investment amount is maintained, and all preferential treatment to be negotiated individually with the MOF²⁶.

② Drawbacks of taxation rules

Examples include the temporary taxation for improving national finance by the Government of Sri Lanka²⁷. Another example is the the Land (Restrictions on alienation) Act regulating disadvantageous rules on land sales or lease by foreign investors in the past. Currently, the land lease tax on the lease of land by foreigners, was abolished on January 1, 2012, based on the budget bill 2016. This Act did not permit foreign investors to purchase land, only allowing them to have a lease agreement that can be valid for up to 99 years. It imposed 15% of the amount of land lease as tax (although now, this land lease tax is no longer charged). It was disadvantageous in terms of cost for investors who consider large-scale investment in manufacturing facilities. General companies need to pay the VAT, Nation Building Tax (NBT) and Economic Service Charge (ESC) in addition to the corporate tax in Sri Lanka and it is costly as investment conditions. As for the VAT specifically, it is 15%, which is higher than that of Thailand (7%) or Singapore (7%) and thus companies that import raw materials from overseas, then manufacture products to export them, are required to pay tariffs equivalent to ordinary tariff on top of other tariffs when they import the raw materials²⁸. Exporters also need to pay tax equivalent to the amount of Output VAT when they pay the National Building Tax (NBT). Although they do not have to pay the output VAT and, as a result, the product cost increases. Competitiveness of Sri Lankan products is diminished because of the taxes that are levied regardless of whether it is a BOI company or not²⁹. However, exporters are given a VAT 0% rate so that any input VAT paid will be refunded, and hence input will not be a cost to the company.

③ Rules on transfer of foreign currencies

Payments for services that are classified as transactions of balance of payments are permitted freely and there is no limitation of overseas money transfer as long as documents on the purpose of the money transfer are submitted. However, investors need to pay attention on the following restrictions, when transferring

²⁶ According to interview with the IMF and information from the Partner of EY Sri Lanka.

²⁷ One example is the special gain tax that is 25% of profit of a company with 2 billion or more Rupees of profit in the relevant tax year. The taxation issue is that the tax was imposed on the profit accumulated in the past. Another example is the excise duty on imported cars that was imposed on 2015 to curve the import volume of such cars.

²⁸ For example, Sri Lanka imposes 15% of tariff on half-finished products as raw materials, intermediate goods and spare parts and there are also such taxes similar to tariff as cess levy (the tax rate varies from several percent to over 30 percent depending on the item), special commodity levy, and ports and airport development levy (7.5% of reported CIF price).

²⁹ According to interview with Japanese manufacturer.

money in consideration of the situation where the Government of Sri Lanka emphasizes acquisition of foreign currencies.

- The transfer of dividends and remaining assets at withdrawal without prior approval under the Exchange Control Act is required to be through an SIA.
- Retained earnings of a branch need to be through an SIA.
- A solvency test has been required for overseas money transfer (regardless of their types including dividends, interest and royalties) since 2014.

④ Status of introduction of the WTO agreement such as advance ruling

The advance ruling stated in the WTO agreement is classified in category C in Sri Lanka, and it has not been introduced yet.

Currently, the Sri Lanka Customs performs advance ruling about HS code, but it is not the same as the advance ruling stated in the WTO agreement as of August 2018. Commodity Classification Branch in the Sri Lanka Customs advises importers or exporters on selection of HS code. In addition, the Sri Lanka Customs responses to questions from traders through helpdesk. Its advice on HS code is effective in procedures of the Sri Lanka Customs as customary, it is not necessarily binding in the administration (the Sri Lanka Government).

The WTO agreement requires the Sri Lankan government to reply requests from traders with legally binding document, however advanced ruling has not been introduced in Sri Lanka yet. Implementation of the articles of the WTO agreement classified in category B and category C requires registration of the New Customs Ordinance. However, the union of the Sri Lanka Customs resists its registration due to fear to lose its authority. And the likelihood of enactment of the New Customs Ordinance in 2018 seems to be low.

In the future, it is preferable to select some priority articles such as the advance ruling from category B and category C that investors and traders strongly wish to introduce as soon as possible, and introduce them by amendments of the existing Customs Ordinance. Gradual introduction of articles of the WTO agreement with high priority and less resistance are expected.

(2) Lack of consistency and predictability

Sri Lankan laws related to FDI promotion are amended frequently. As a result, their consistency and predictability of projects are diminished. VAT Act amendments are described in an example below.

It was decided that the VAT rate will be raised from 11% to 15% on May 2, 2016, based on the notice on April 29 by the Commissioner General of the IRD. However, the validity of the notice was suspended by the Supreme Court decision on May 8. On June 24, the VAT Amendment Bill to raise the rate to 15% passed the Parliament and it was decided to be applied retroactively from May 2.

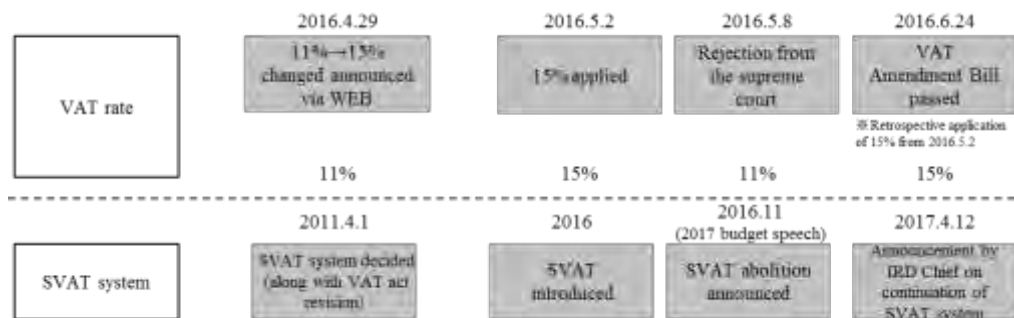


Figure 3-4 Amendment of VAT in the Recent Years

Source: Survey team based on interviews

As the history of the revision indicates, the legal system is based on the common law where laws are applied in accordance with actual situation after legal precedents. Amendments of the original law, prepositions of business conditions change easily, which makes it difficult for investors to operate business without predictability. Particularly, Japanese investors see the frequent amendments and the interpretation of laws based on precedents as large difference in the business environment between Japan and Sri Lanka.

The Government of Sri Lanka annually submits the budget speech of the following year in November, where the tax system and rate changes are indicated. Changes of taxation rules of the following year in response to the budget speech are often completed with a simple notice³⁰. According to another company, the export ratio that is a requirement for tax incentives was raised suddenly for the government to increase the income of foreign currencies³¹.

As a specific example, the SVAT scheme that was introduced in April 1, 2011 by an amendment of the VAT act [section 2(2)] to shorten the time required for VAT refund, and simplify the process.

It was announced in the 2017 budget speech³² that the SVAT scheme was to be abolished. It not only

³⁰ For example, the value added tax (VAT) rate rose from 11% to 15% only with notice on IRD website in FY2016 (The notice was posted on April 29, 2016, and the new rate was introduced on May 2.) However, it was refused under the Supreme Court decision that it was not through formal legislation procedures. The VAT Amendment Bill was enacted on June 24, 2016, and applied retroactively to transactions from May 2. The Economic Service Charge rate that was 2.5% until March 31, 2015, was stated to change to 5.0% in the 2016 budget bill. It was changed based on the notice posted on the websites of the MOF and IRD on April 8, 2016. The new rate was applied to transactions from April 1 without waiting for the amendment of the ESC Act.

³¹ According to interview with Japanese Porcelain manufacturer.

³² The SVAT scheme was introduced as VAT return for importing companies, etc., requires time when they have a large amount of Input VAT to be levied at purchase. In the scheme, registered companies (importing companies) no longer need

goes against the policy intention of SVAT introduction, but the abolishment of a new scheme soon after its introduction would waste the investment for training toward systematization and introduction³³.

However, “Notice to The Tax Payers – Implementation of Changes Proposed in Budget 2017” on April 12, 2017 issued by IRD states “As instructed by the MOF, the taxpayers are informed that the existing provisions of the Inland Revenue Act, the Value Added Tax Act and the Nation Building Tax Act will continue until further notice”. Therefore, the abolishment of the SVAT scheme will not be done for the time being. It is possible that the amendment of the VAT act to abolish the SVAT scheme is postponed due to dissenting voices from business community.

The hasty legal revisions and inconsistent changes of schemes, along with insufficient notice of latest information, leave room for different interpretation of application of laws to officials in charge. It is an unstable factor related to conducting business in Sri Lanka.

According to interviews with companies that established business in Sri Lanka, they build strong partnerships with influential local figures, as a key to responding to such laws and rules. They leave problem solving to top supervising ministry officials in charge, using the relationship with the local partners to oppose to the inconsistent interpretation of laws by officials in charge. Although the settlement through such unwritten processes may be unavoidable when the legal system is not sufficiently developed, it is desired that a transparent and consistent investment climate is developed by communication between stakeholders and establishment of a formal solution process for Sri Lanka to become an open country for investors.

3.3 FDI Approvals

3.3.1 Approval to be obtained by FDI providers

Business activities that are not permitted for foreign investors or business that are required to obtain approval from the government, are provided in Gazette No. 1232/14 (and No.1248/19) under the Exchange Control Act. There is no limitation of investment by foreign capital in other businesses as shown below.

(1) Exclusions

- Money lending other than the business of providing of credits to investors to purchase securities of a listed company by a company registered as a margin provider in terms of Section 19(A) of the Securities and Exchange Commission of Sri Lanka Act 36 of 1981 as amended
- Pawn broking
- Retail trade with a capital of less than One Million US Dollars
- Coastal Fishing
- Provision of Security Services including Security, Consultancy to individuals or Private Organizations

to post the Input VAT as it is not levied on the transactions when they purchase from registered companies (suppliers).

³³Results of interview with Japanese service provider.

(2) Limitations: Foreign investments in the areas listed below will be approved only up to 40% of the issued capital, or a higher percentage if approval has been granted by the Board of Investment of Sri Lanka.

- Production of goods that are subject to internationally determined quota restriction when exporting from Sri Lanka
- Growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices
- Mining and primary processing of non-renewable national resources
- Timber based industries using local timber Fishing (Deep Sea fishing)
- Mass Communication
- Education
- Freight Forwarding
- Travel Agencies
- Shipping Agencies

(3) Businesses requiring permission from corresponding ministries or the BOI. Investment rate could be decided by the BOI.

- Air transportation
- Coastal shipping
- Large Scale mechanized mining of gems
- Lotteries
- Industrial enterprise in the Second Schedule of the Industrial Promotion Act, No. 46 of 1990, namely – any industry manufacturing arms, ammunitions, explosives, military vehicles and equipment aircraft and other military hardware; any industry manufacturing poisons, narcotics, alcohols, dangerous drugs and toxic, hazardous or carcinogenic materials; any industry producing currency, coins or security documents

Investment in businesses other than the above requires business operators to acquire approvals, at least 17 approvals for medical equipment manufacturing, but the number of approvals to be obtained varies in accordance with the business sector and scale of investment. Table 3-8 provides necessary approvals mentioned on the BOI investment guidebook, and relevant ministry agencies in charge.

Table 3-8 Necessary approvals and administrative procedures required for foreign investors and relevant government entities

| Necessary approvals and administrative procedures | Ministry or agency in charge | Average time required |
|---|---|-----------------------|
| Company registration | <ul style="list-style-type: none"> • Dept. of Registrar of Companies • BOI Appraisal Department | One or two days |
| Preliminary Clearance | <ul style="list-style-type: none"> • Ministry of Health • Dept. of Health Services | Depend by project |
| Environmental Clearance | <ul style="list-style-type: none"> • Central Environmental Authority • Provincial Environmental Authority • Environment Management Department of the BOI | Depend by project |

| Necessary approvals and administrative procedures | Ministry or agency in charge | Average time required |
|---|---|---|
| Land Clearance | <ul style="list-style-type: none"> • Not necessary if investors are located within EPZ • Otherwise, relevant Land Owner [Land Commissioner General's Department/UDA³⁴, LRC³⁵ SLLRDC³⁶/ Forest Dept., Wildlife Dept. etc.] | About one to two months (Including tendering period) |
| Site Approval | <ul style="list-style-type: none"> • Local Authority • BOI • Eng. Approvals – BOI | About a week |
| Building plan approval | <ul style="list-style-type: none"> • Local Authority • BOI • Eng. Approvals – BOI | About a week |
| Work Permit & Res. Visa | <ul style="list-style-type: none"> • Ministry of Internal Affairs, Immigration and Emigration • Ministry of Defence • BOI | About two to three weeks (from application to permission) |
| VAT/TIN | <ul style="list-style-type: none"> • IRD | One or two days |
| Import-Export Registration | <ul style="list-style-type: none"> • Import and Export Controller | One or two days |
| Electricity | <ul style="list-style-type: none"> • Ceylon Electricity Board (CEB) | Depend by project |
| Water | <ul style="list-style-type: none"> • National Water Supply & Drainage Board | Depend by project |
| Telecommunication | <ul style="list-style-type: none"> • Sri Lanka Telecom/Private Company | Depend by project |
| COC | <ul style="list-style-type: none"> • Relevant Local Authority • Engineering Approvals Department of the BOI | One or two days |
| EPL ³⁷ | <ul style="list-style-type: none"> • Central Environmental Authority • Provincial Environmental Authority • Environment Management Department of the BOI | About a week |
| ROO | <ul style="list-style-type: none"> • Department of Commerce | Depend by project |
| Chemical approvals | <ul style="list-style-type: none"> • To be obtained from following agencies, through Environment Management Department • Investor Services Department of the BOI if required; (Import & Export, Precursor Control Authority, industry and Commerce, National Ozone unit of the Ministry of Mahaweli, National Fertilizer Secretariat) | Depend by project |

Source: Interview with BOI officers

³⁴ Urban Development Authority

³⁵ Local Resettlement Committee

³⁶ Sri Lanka Land Reclamation and Development Corporation

³⁷ Depending on the investment project, the license may be valid for 1 year or 3 years.

3.3.2 Procedures to obtain approvals

The following procedures to obtain approvals are introduced via the BOI website.

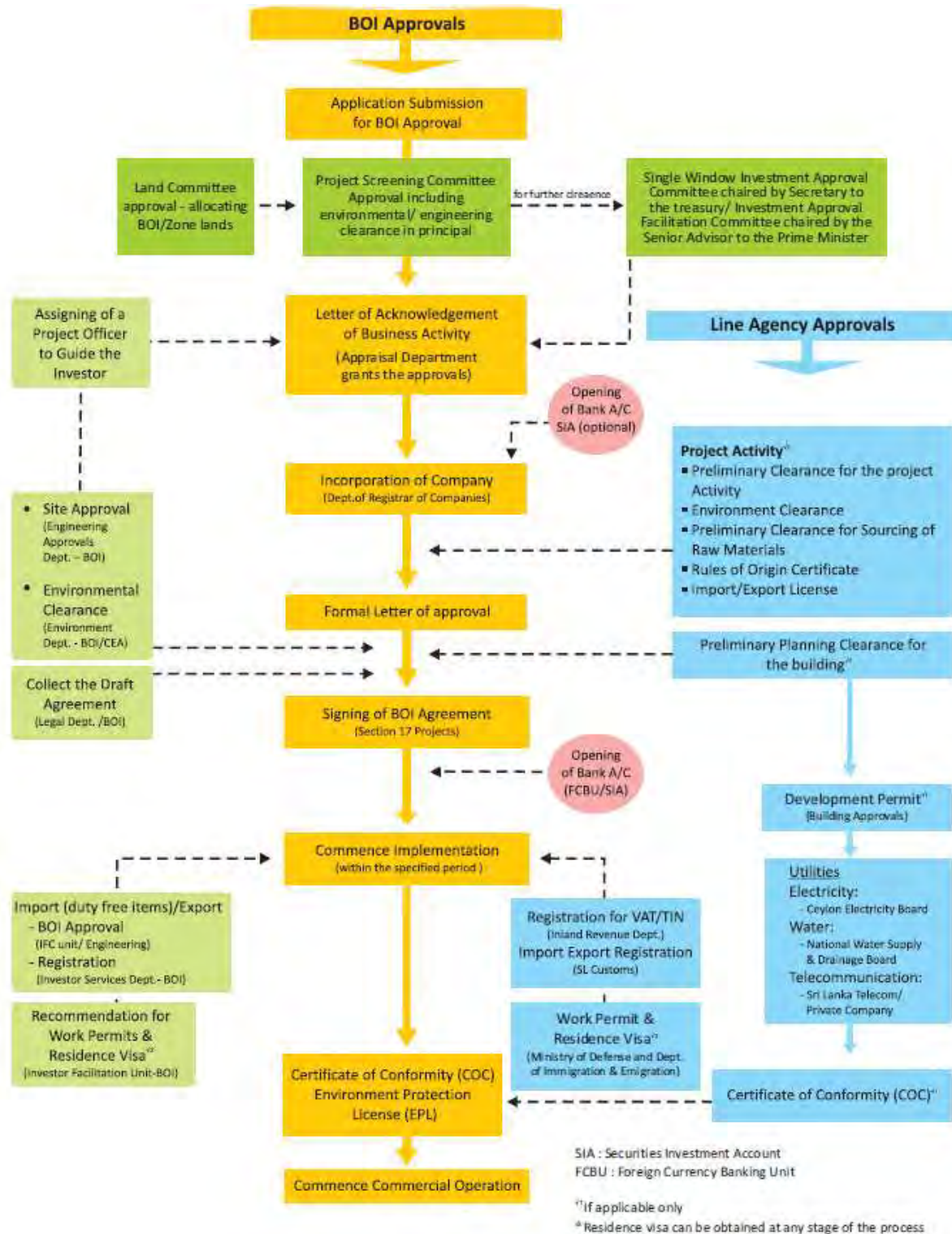


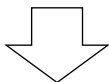
Figure 3-5 BOI Approval Process

Source: BOI, Investment Guide, 2017

The outline of the investment approval procedures is as given above. Concrete procedures in each step from the submission of application document by the investor to the commencement of business are described in the following.

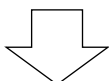
Step 1: The investor submits an application document to the BOI.

- It is necessary to submit an application form for Article 16 and Article 17 of the BOI Act, respectively.
- It is required to describe the outline of the investor, outline of the investment project (investment plan, financing plan, personnel plan), scheduled amount of money transferred overseas, programme until the start of commercial activities in the application form.
 - ※While the application for Article 16 only requires the outline, the application for Article 17 requires detailed description of the plans. For example, it is necessary to describe the ratio of annual export and domestic sales for each product, specific equipment investment plan and cash flow plan for the application year and the following year, fund procurement plan, employment plan of foreign and local personnel for each position, etc.



Step 2: The Screening Committee of the BOI examines the business content, and issues the “Letter of Acknowledgement”.

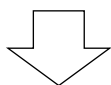
- Since the land managed by the BOI is insufficient at present, if the investor wishes to use the land managed by the BOI (including the land of the EPZ), it is necessary to obtain a land clearance after bidding. (See below for specific procedures.)
- The investor needs to obtain a site approval from the Approvals Department of the BOI to use the site managed by the BOI. The scheduled investment site is surveyed and impact on the surrounding environment is examined to determine the eligibility as the investment site.
- The investment project is inspected to ensure compliance with environmental regulations and it is also necessary to receive an environmental clearance certificate from the Environment Management Department of the BOI and the Central Environment Authority.
 - ※To use the land outside the jurisdiction of the BOI, the investor needs to individually negotiate with the Land Development Authority and other relevant organizations as well as the land owner and after the feasibility study, the investor also needs to obtain an equivalent result from the land owner. The environmental clearance certificate and the environmental protection license (EPL) are issued by the BOI with the agreement of the Central Information Authority.



Step 3: The investor registers the company.

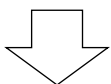
- See appendix for the procedure to establish corporations.
- For the investor to receive an investment permit, it is necessary to obtain permissions and approvals from line ministries for each investment sector. For example, it is necessary to

obtain an approval concerning the business content, prior approval for the procurement source of raw materials, certificate of origin, import/export license, etc.

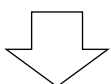


Step 4: The BOI issues the “Letter of Approval” and approves the business.

- For the evaluation of large-scale investments and projects with high added values, the “Single Window Investment Approval Committee” has been set up. This Committee is a conference body comprised of six senior officials including the BOI director general and is chaired by the vice minister of the MOF.
- In order to promptly solve critical issues faced by investors when starting commercial activities, the “Investment Appraisal Facility Committee” has been set up. This Committee is a conference body established under the Prime Minister’s Office and it consists of four senior officials and is chaired by the senior advisor to the Prime Minister.



Step 5: The investor concludes the “BOI Agreement” with the BOI.



Step 6: The investor commences business.

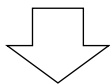
- After the concluding the agreement with the BOI, in accordance with the guideline determined by the BOI, the investor needs to develop a building and design plan and obtain a prior approval from the Engineering Approval Department of the BOI³⁸. After that, when the construction is complete, the same department performs an inspection to check if the building has been built according to the approved plan, and is fit for business use, and issues the certification of conformance.
- The investor is required to obtain the EPL before the start of commercial activities. The application should be filed to the Environment Management Department of the BOI, no later than one month prior to the scheduled start of business and after the building is inspected for conformance to regulations related to environment management, the EPL is issued. It is also necessary for the investor to obtain a license for solid waste management from the Central Environment Authority.
- Aside from the above, it is deemed necessary to complete the following acquisition and registration procedures before the start of business.

(1) Acquisition of taxpayer identification number (TIN) and VAT business registration³⁹

³⁸ The application form for each building use is available on the BOI website (http://www.investsrilanka.com/services/engineering_approvals).

³⁹ The application document may be obtained from the website of the IRD (<http://www.ird.gov.lk/>) or the office of the Department.

- (2) Acquisition of the EPF⁴⁰ and the ETF⁴¹
- (3) Opening of bank account (SIA or IIA)
- (4) BOI approval and registration for import (duty free goods)/export
- (5) Acquisition of work permit and resident visa (See below for specific procedures.)
- (6) Application for use of electricity, water and telecommunication system

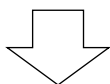


Step 7: The investor commences commercial activities.

【Procedure for acquisition of land clearance for the land managed by BOI】

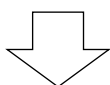
Generally, the following steps are taken in order for a foreigner to acquire a land clearance for the land managed by the BOI.

Step 1: BOI publicly announces the information of available land.

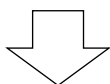


Step 2: Investors make a bid.

- Investors are requested to present the project outline and information on the investment amount [land premium, rental fee, rental period (50 years for the longest) in bidding] .



Step 3: The Screening Committee and the Land Committee evaluate the proposed projects by consulting with relevant organizations.



Step 4: The investor who received the highest evaluation concludes the “BOI Agreement” with the BOI⁴².

【Procedure for acquisition of work permit and resident visa】

Acquisition of a resident visa is required for a foreigner to work in Sri Lanka. The procedure for the acquisition of the visa is as follows.

Step 1: The investor requests the competent ministry for permission to send expatriates.

- If the investor is a BOI company, the investor may request the BOI to issue a letter of

⁴⁰ EPF stands for the Employee’s Provident Fund. It is a social security scheme that the employer is responsible for contributing to and was established as a reserve fund system to ensure the security of the life of employees of private companies and governmental companies after retirement. In the case of private companies, 12% of the total revenue of the employee, including benefits, is contributed by the employer and 8% is contributed by the employee.

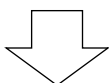
⁴¹ ETF stands for the Employee’s Trust Fund. It is a social security scheme that the employer is responsible for contributing to and was established as a fund scheme to ensure security after unemployment and retirement. The employer bears 3% of the benefit to the employee.

⁴² According to the information from EY Sri Lanka, evaluation of the proposals focuses on the minimum investment requirement and the amount described in the Extraordinary Gazette of November 2, 2006 (USD 1 million /acre) is regarded as a guide. As such, an investor with a high bid is most likely to win.

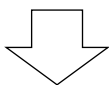
recommendation in writing. The letter of recommendation is prepared by the BOI and addressed to the Department of Immigration and Emigration and it recommends the issuance of visa required for the expatriates to enter the country. It is required to describe the following information when requesting the letter of recommendation.

(In the case of non-BOI companies, companies may request for recommendation to corresponding line ministries of their business, or request VISA from the Department of Immigration and Emigration directly.)

- Name and nationality of prospective expatriate
- Passport number and identification
- Designation
- Employment period
- Scheduled date of entry
- Reason for employment

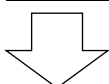


Step 2: After receiving the recommendation from the competent ministry or the BOI, the Department of Immigration and Emigration requests the Sri Lankan embassy of the country where the expatriate lives to issue an entry visa to Sri Lanka.



Step 3: The expatriate receives the entry visa and enters Sri Lanka.

- If the investor is a BOI company, after entering the country, the expatriate requests the BOI to issue a new letter of recommendation. This letter is prepared by the BOI and addressed to the Department of Immigration and Emigration and it recommends the issuance of a resident visa required for the expatriate to work in Sri Lanka.



Step 4: The expatriate applies for the issuance of resident visa and work permit to the Department of Immigration and Emigration.

- If the investor is a BOI company, the letter of recommendation should be submitted at the time of application. The Department of Immigration and Emigration issues the resident visa after completing a prescribed procedure⁴³. The resident visa is valid for 12 months for the

⁴³ With respect to the employment of foreigners, there is no rule that stipulates the number of employable personnel, types of jobs, etc. and as such, they depend on the number of employees and the investment amount and are determined in the course of negotiation with the BOI. For example, according to a Japanese manufacturer, an application for a Japanese expatriate as a sales representative was not approved by the BOI, but an application for the same person as a project development officer was approved, and according to a Japanese service provider, when an attempt was made to bring an engineer from Japan, work permit was not approved, but in the case of a company of another country, even those who obviously do not have an adequate academic background or skills easily obtained a visa.

longest and can be renewed in accordance with the recommendation of the BOI⁴⁴.

- To obtain a work permit at the investor status, it is optional for the investor to open a dedicated bank account (Resident Guest Foreign Currency Accounts :RGFCA) and transfer at least USD 250,000 by using the Resident Guest Scheme Visa Programme which allows investors to stay in Sri Lanka maximum 5 years, separate from the investment amount required to conclude the agreement with the BOI⁴⁵.

3.3.3 Registration with the Board of Investment

(1) Companies in Articles 16 and 17

When an investor incorporates a company in Sri Lanka, he/she registers it as a company that does not receive tax incentives under Article 16 of the BOI Act, or as a company that receives tax incentives under Article 17. Companies that are not exporting may conduct business without registration as BOI companies, and operate as the so-called non-BOI company. For example, if the investment amount is small, does not export any goods (e.g. restaurant, etc.), and can solve their business-related problems (such problems as delay in obtaining visa for Japanese employees or custom processing issues etc.), investors may not register as BOI companies.

Decision on the registration with the BOI will be based on whether they can enjoy the advantage as registered companies, despite paying annual fees agreed on plus the additional compensation for the service they receive to the BOI.

All investors considering investment in Sri Lanka are able to receive the provision of *information* by the BOI at the stage of considering the investment, but they cannot receive any *service* after they set up a non-BOI company in Sri Lanka. In reality, it is institutionally possible for a foreign investor to advance to Sri Lanka as a non-BOI company without obtaining an approval from the BOI. More specifically, to start a business, the investor must incorporate a company in accordance with the Corporate Law, and register the company at the Registrar. Then, he/she must complete the necessary administrative procedures to obtain approvals, environmental clearance, etc. from line ministries as required for starting commercial activities. Similarly, he/she must individually file an application to the competent ministry for the acquisition of visa as they cannot obtain a letter of recommendation from the BOI for the employment of foreigners. Preferential treatment to receive as a section 16 and section 17 companies are different. Section 16 companies could receive VISA application support, whilst no preferential treatment on tax are given. For section 17 companies, import tariff on machinery, exemption from exchange control regulation⁴⁶, VISA acquisition support for foreign employees and their family are given.

⁴⁴ Directors are able to stay for a maximum of two years. The Budget Proposal of 2017 proposes a multiple visa valid for five years at the longest for investors and highly skilled foreign engineers.

⁴⁵ This is based on the Exchange Control Operating Instructions No. 06/04/06/2007 of 19.03.2007. However, according to Japanese apparel products manufacturer, the company was not required to open an account or transfer a certain amount of money as described above. According to Japanese automobile parts manufacturer, although it was necessary to transfer USD 250,000, the company fulfilled the requirement by opening a Foreign Currency Banking Unit (FCBU) account.

⁴⁶ Part I, IA, II, III, IV V & VI of the Exchange Control Act are exempted, enabling the opening of FCBU without fulfilling the qualification to export more than 90% of products.

(2) Approvals granted in the past 5 years

Table 3-9 and Table 3-10 shows the transition of the number of non-BOI companies and their investment amounts in the past five years. The values of Companies Registered and Estimated Investment are cumulative values and the figures for 2015 are provisional values. The trend of the number of companies that are approved under Articles 16 and 17 of the BOI Act is displayed in the table below. The number in year 2015 is provisional. Following tables indicate that investment from BOI registered companies exceed that to non-BOI companies, both on number of investments and estimated investments. Especially for estimated investment amount, BOI registered companies show substantially larger investment.

Table 3-9 Number of investment projects for BOI, including expansion and Non-BOI companies

| | Number of investment projects | | | | |
|---|-------------------------------|-------|-------|-------|-------|
| | 2011 | 2012 | 2013 | 2014 | 2015 |
| BOI companies | | | | | |
| Projects received letter of acknowledgement | 183 | 269 | 205 | 214 | 233 |
| Under Section 17 | 23 | 32 | 36 | 27 | 16 |
| Under Section 16 | 160 | 237 | 169 | 187 | 217 |
| Projects Contracted Under Section 17 | 164 | 162 | 138 | 152 | 150 |
| Realised Investment Under Section 17 | 2,019 | 2,045 | 1,997 | 1,951 | 1,989 |
| Projects in Commercial Operations | 2,693 | 2,704 | 2,656 | 2,748 | 2,823 |
| Under Section 17 | 806 | 706 | 712 | 718 | 726 |
| Under Section 16 | 1,887 | 1,998 | 1,944 | 2,030 | 2,097 |
| Non-BOI companies | | | | | |
| Commercial registration | 2,006 | 2,048 | 2,100 | 2,192 | 2,276 |

Source: Survey Team, based on information obtained from Board of Investment of Sri Lanka, Ministry of Industry and Commerce

Note: Flow for Projects received and contracted, and Stock for number of registered projects for other numbers

Table 3-10 Amount of estimated investment projects for BOI, including expansion and Non-BOI companies

| | Amount of estimated investment (Rs.million) | | | | |
|---|---|-----------|-----------|-----------|-----------|
| | 2011 | 2012 | 2013 | 2014 | 2015 |
| BOI companies | | | | | |
| Projects received letter of acknowledgement | 494,832 | 706,947 | 501,512 | 401,780 | 429,305 |
| Under Section 17 | 3,541 | 3,992 | 4,380 | 12,533 | 3,209 |
| Under Section 16 | 491,291 | 702,955 | 497,132 | 389,247 | 426,096 |
| Projects Contracted Under Section 17 | 371,383 | 405,394 | 529,967 | 263,569 | 282,632 |
| Realised Investment Under Section 17 | 1,032,613 | 1,280,837 | 1,512,021 | 1,755,702 | 1,991,808 |
| Projects in Commercial Operations | 4,208,359 | 4,348,788 | 4,378,875 | 4,552,938 | 4,603,081 |
| Under Section 17 | 29,508 | 31,564 | 31,894 | 33,582 | 45,365 |
| Under Section 16 | 4,178,851 | 4,317,224 | 4,346,981 | 4,519,356 | 4,557,716 |
| Non-BOI companies | | | | | |
| Commercial registration | 150,268 | 153,303 | 202,219 | 203,764 | 204,522 |

Source: Prepared by project team based on the information from Board of Investment of Sri Lanka, Ministry of Industry and Commerce

Note: Flow for Projects received and contracted, and Stock for number of registered projects for other numbers

(3) Discussions on requirements and decision-making criteria

Following table introduce the requirements to be BOI companies.

Table 3-11 Qualification requirement for BOI registered companies

| | Section 16 | Section 17 |
|---------------------------|---|--|
| Qualification requirement | Minimum investment requirement USD 250,000 (Either 100% foreign investment or a joint venture investment with a local collaboration) | (In accordance with BOI Regulation No.2 of 2006) |
| Screening process | Once application is submitted by investors, it is approved after examination within BOI and in consultation with line agencies. | |

Source: Interview with BOI officers and reference to Investment Guide published by BOI

BOI Regulation No.2 of 2006 (Gazette #1469/35, 2006) provides minimum investment requirements in accordance with the type of business, the amount of investment, and the number of employees. BOI Regulation No.2 of 2006 specifies ① quantitative standards for companies that plan to make investment in Sri Lanka, and the ② qualifications to receive incentives as Article 17 companies of the BOI .

The Inland Revenue Act which was implemented in 2011 set new qualifications for receiving incentives. As a result, the act became effective on top of the ② qualifications to receive incentives as article 17 companies of BOI Regulation No.2 of 2006.

However, in actual practice of the BOI, these investment standards are used as reference material and not as decision making criteria on qualifications to register as Article 17 Company. There is confusion among BOI staff on the use of standards, hence there have been cases where request for visa issuance or increase in employees based on BOI decree No.2 of 2006 as their grounds from companies have been declined. Clarification and awareness rising of effective law and regulations are needed.

Table 3-12 Requirements to be Sec.17 Companies

| | Threshold for approving Section 17 company | Requirements for granting tax holidays | Current status |
|-------------------------|--|--|--|
| BOI Regulation #2, 2006 | ○ | × | Referred as a guideline for BOI registration, granting of working permit, but not utilized for formal guide when approving tax exemption as Section 17 company |
| IRA, 2011 | | ○ | Granting tax incentive was under the IRA 2011, of which had been abolished with the review of IRA in 2017. |

Source: Prepared by project team

As shown in the table above, the minimum investment requirements, number of Sri Lankan employees, and appraisal criteria for new businesses specified in BOI Regulation No.2 of 2006 are used as referential decision-making criteria by BOI employees, when it grants approval to investors as Article 17 companies

(BOI companies), after the abolishment of granting tax exemptions in 2011. The Gazette provides 19 forms of conditions for granting tax holiday, classifying them into four categories, namely, a) Minimum investment amount; b) Minimum investment amount and number of employees; c) Sales; d) Minimum investment amount, number of personnel trained and number of training facilities installed. It should be noted that, currently, no procedure has been taken to abolish this decree.

Table 3-13 BOI's Decision-Making Criteria for Qualification (Minimum Investment Requirement)

| Business Types | Qualification Requirement | |
|---|--|---------------------|
| | Minimum Investment (USD or its equivalent in Sri Lanka Rupees) | Period of Exemption |
| Enterprise that engages in the production or manufacture of non - traditional goods for export including deemed/indirect exports of not less than eighty per centum (80%) of its output | 250,000 | 3 |
| | 500,000 | 5 |
| | 1,000,000 | 7 |
| Enterprise that engages in the export of services and receives not less than seventy per centum (70%) of its turnover in convertible foreign currency | 500,000 | 5 |
| Enterprise that engages in the manufacture of industrial tools, equipment, components and machinery | 150,000 | 5 |
| Enterprise that engages in power generation, tourism, construction and operation of warehouses including logistic and supply chain management, construction of houses comprising, any special project as approved either by the Cabinet of Ministers or by the Cabinet Sub-Committee on Investment Facilitation | 500,000 5,000,000 (in any other infrastructure or construction activity as may be approved by the Board) | 5 |
| Enterprise that establishes a regional operating headquarters and receive not less than seventy per centum (70%) of its turnover in convertible foreign currency: administration, business planning and co-ordination, sourcing of raw materials and components, research and development services, technical support services, financial and treasury management ; and marketing and sales promotion | 250,000 | 3 |
| Enterprise that engages in advanced technology or pioneering nature | 5,000,000 | 5 |
| Enterprises that engages in research and development | 100,000 | 5 |
| Enterprise that engages in either agriculture and agro-processing or in agriculture or agro-processing | 150,000 | 5 |
| Enterprise that undertakes modernization of food and beverages processing units in the export plantation sector | 150,000 | 5 |
| Enterprise that is formed by the acquisition of assets of any existing enterprise engaged in a large scale project relating to petroleum and petroleum products, power generation, transmission and | 12,500,000 | 5 |
| | 25,000,000 | 6 |
| | 50,000,000 | 8 |

| Business Types | Qualification Requirement | Period of Exemption |
|---|---|---------------------|
| | Minimum Investment (USD or its equivalent in Sri Lanka Rupees) | |
| distribution, development of public infrastructure or agriculture and agro processing services other than processing of black tea in bulk or any other infrastructure project as may be approved by the Board | | |
| Enterprise that engages in a large scale project relating to power generation, transmission and distribution, public transport infrastructure, any other infrastructure project as may be approved by the Board, or large scale manufacturing or service industry project or any other business activity for export as may be approved by the Board | 12,500,000 | 6 |
| | 25,000,000 | 8 |
| | 50,000,000 | 10 |
| | 75,000,000 | 12 |
| | 100,000,000 | 15 |
| Enterprise that engages in a large scale project relating to the establishment of Industrial Estates including the development and management of Industrial Estates or Special Economic Zones | 500,000 | 3 |
| | 1,000,000 | 5 |
| | 5,000,000 | 6 |
| | 10,000,000 | 7 |
| | 15,000,000 | 8 |
| | 20,000,000 | 9 |
| | 25,000,000 | 10 |
| | 75,000,000 | 15 |
| Enterprises that engages in the production or manufacture for export of textile and fabric manufacturing, printing, dyeing, washing and finishing, provided that it exports (including deemed exports) not less than eighty per centum (80%) of its products | 500,000 | 5 |
| | 1,000,000 | 8 |
| | 5,000,000 | 10 |
| | 7,500,000 | 12 |
| | 10,000,000 | 15 |
| Enterprise that establishes or sets up an export trading house for the rural sector exporting the entirety of the procured agricultural products, handcraft items, handloom and other locally manufactured products other than apparel or any other rural products | 150,000 | 5 |

Source: Survey team, based on information in BOI decree No.2 of 2006

Table 3-14 BOI's Decision-Making Criteria for Qualification (Minimum investment amount and number of employees)

| Business Types | Qualification Requirement | | Period of Exemption |
|--|--|------------------|---------------------|
| | Minimum Investment (USD or its equivalent in Sri Lanka Rupees) | No. of Employees | |
| Enterprise that engages either in information technology and information technology enabled services or in information technology or information technology enabled services (include not less than fifteen technically qualified local persons) | 150,000 | ~250 | 5 |
| | | 251~400 | 6 |
| | | 401~600 | 7 |
| | | 601~800 | 8 |
| | | 801~1,000 | 10 |
| | | 1,001~2,000+ | 12 |
| Enterprise that engages in a Business Process Outsourcing Industry and receives not less than seventy per centum (70%) of its turnover in convertible foreign currency | 150,000 | ~100 | 3 |
| | | 101~250 | 5 |
| | | 251~500 | 6 |
| | | 501~1,000 | 8 |
| | | 1,001~1,500 | 10 |
| | | 1,501~2,000+ | 12 |

Source: Survey team, based on information in BOI decree No.2 of 2006

Table 3-15 BOI's Decision-Making Criteria for Qualification (Sales)

| Business Types | Qualification Requirement | |
|--|--|---------------------|
| | Minimum Investment (USD or its equivalent in Sri Lanka Rupees) | Period of Exemption |
| Enterprise that engages in the business of an export trading house exporting the entirety of the locally procured manufactured products and re-exporting the entirety of the imported products, provided that it locates its warehouse within an Export Processing Zone of the Board or an approved Customs Bonded Warehouse located outside an Export Processing Zone | 5,000,000-10,000,000 | 10% |
| | 10,000,000-25,000,000 | 5% |
| | 25,000,000- | 0% |

Source: Survey team, based on information in BOI decree No.2 of 2006

Table 3-16 BOI's Decision-Making Criteria for Qualification (Minimum investment amount, number of personnel trained and number of training facilities installed)

| Business Types | Qualification Requirement | | | Period of Exemption |
|---|--|---|--|---------------------|
| | Minimum Investment (USD or its equivalent in Sri Lanka Rupees) | No. of Students to be Trained per annum | No. of Units Outside Colombo and Gampaha Districts | |
| Enterprise that establishes a training institute consisting of, or undertakes to carry out training | 100,000 | 250 | - | 5 |
| | | 500 | 1 | 6 |
| | | 750 | 2 | 7 |
| | | 1,000 | 3 | 8 |
| | | 1,250 | 4 | 9 |
| | | 1,500 | 5 | 10 |
| | | 1,750 | 6 | 11 |
| | | 2,000 | 7 | 12 |
| Enterprise that establishes a expansion units for training institutes and engages in training | 100,000 | 500 | 1 | 6 |
| | | 750 | 2 | 7 |
| | | 1,000 | 3 | 8 |
| | | 1,250 | 4 | 9 |
| | | 1,500 | 5 | 10 |
| | | 1,750 | 6 | 11 |
| | | 2,000 | 7 | 12 |

Source: Survey team, based on information in Gazette #1469/35

(4) Hub operation regulation

The Commercial Hub Regulation No.1 of 2013 is another scheme granting preferential treatment to investors in addition to BOI registration. The hub operation regulation scheme sets six designated free ports and bonded districts, and tax incentives are granted to business activities in and outside the area (excluding corporate tax).

Table 3-17 Declared Free ports and bonded areas under Hub Regulation Act

| | |
|------------------------------------|--|
| Declared Free Ports | Colombo and Hambantota |
| Declared Bonded Areas | Katunayake EPZ & Koggala EPZ |
| Specified Bonded Areas | Mattala Rajapaksha International Air Port & Mirijawila EPZ |
| Outside Free Ports or Bonded Areas | Other ports or areas |

Source: Prepared by project team from BOI website and Commercial Hub Regulation No.1 of 2013

Tax reduction and exemption are provided when designated to be qualified for the scheme and the preferential treatment is listed below.

Table 3-18 Exemptions under Commercial Hub Regulation

| |
|--|
| Customs Ordinance |
| Exchange Control Act |
| Imports and Exports Control Act, No.1 of 1969 |
| Value Added Tax Act, No.14 of 2002 |
| Nation Building Tax Act, No.9 of 2009 |
| Sri Lanka Export Development Act, No.40 of 1979 |
| Special Commodity Levy Act, No.48 of 2007 |
| Ports and Airports Development Levy Act, No.18 of 2011 |
| Excise (Special Provisions) Act, No.13 of 1989 |

Source: Prepared by project team from BOI website and Commercial Hub Regulation No.1 of 2013

The required minimum amount of investment is calculated from the time of signing of the BOI agreement and 65% of the total amount is required to be transferred through the Foreign Currency Banking Unit (FCBU) account or from overseas. The export sales are required to be achieved within five years.

The six companies in the table below are qualified for the designation as of August 2017.

Table 3-19 Companies in operation registered under Commercial Hub Regulation

| Company Name | Activity | Nationality |
|--|-------------------------------|-------------|
| A P L Logistics Lanka(PVT) Ltd. | Logistics services | Singapore |
| Addis Ventures (PVT) Ltd. | - | |
| Expo Global Distribution Centre (P) Ltd. | Warehouse, Logistic services | Singapore |
| Global Auto Manufacturing Ltd. | Auto maintenance | Japan |
| Global Outlets (PVT) Ltd. | Warehouse, Logistics services | Lebanon |
| Hayleys Free Zone Ltd. | Entrepôt trade | Sri Lanka |

Source: Prepared by project team based on an interview with BOI officers

As described in 3.1.3, the Single Window Investment Approval Committee and the Investment Appraisal Facility Committee are set up to accelerate the process, and efforts are made to shorten the delay in issuance of approvals by line ministries.

3.4 Investment-related polices and schemes

3.4.1 Investment-related polices

Sri Lanka is ranked 110th among 190 countries in the Doing Business (DB) business climate appraisal report (2017) by the World Bank (WB), which is almost the same as the rank in its 2016 version. The business environment has not improved since the previous year excluding the situations of Starting a

Business, Protecting Minority Business and Resolving Insolvency.

In to the World Bank’s “Doing Business Index 2017”, Sri Lanka places 110 in ranking (109 in 2016) which is next to Nepal (rank 107) and above India (rank 130). Similar ranking countries are Ghana, Namibia, Swaziland and Belize. Sri Lanka’s PIP targeted is to raise Sri Lanka’s ranking below 70 by 2020.

Table 3-20 Doing Business 2017 results of Sri Lanka

| | 2017 Rank | 2016 Rank | Change | 2017 DTF ⁴⁷ Score | 2016 DTF Score | Change |
|-----------------------------------|-----------|-----------|--------|------------------------------|----------------|--------|
| Overall | 110 | 109 | +1 | 58.79 | 58.14 | +0.65 |
| Starting a Business | 74 | 95 | +21 | 87.52 | 84.98 | +2.54 |
| Dealing with Construction Permits | 88 | 83 | ▲5 | 69.31 | 69.25 | +0.06 |
| Getting Electricity | 86 | 82 | ▲4 | 71.12 | 70.82 | +0.30 |
| Registering Property | 155 | 154 | ▲1 | 46.76 | 46.76 | — |
| Getting Credit | 118 | 109 | ▲9 | 40.00 | 40.00 | — |
| Protecting Minority Investors | 42 | 51 | +9 | 63.33 | 60.00 | +3.33 |
| Paying Taxes | 158 | 157 | ▲1 | 53.16 | 53.18 | ▲0.02 |
| Trading Across Borders | 90 | 89 | ▲1 | 70.70 | 70.70 | — |
| Enforcing Contracts | 163 | 163 | — | 39.31 | 39.31 | — |
| Resolving Insolvency | 75 | 76 | +1 | 46.73 | 46.40 | +0.33 |

Source: Survey team based on Doing Business 2017, World Bank

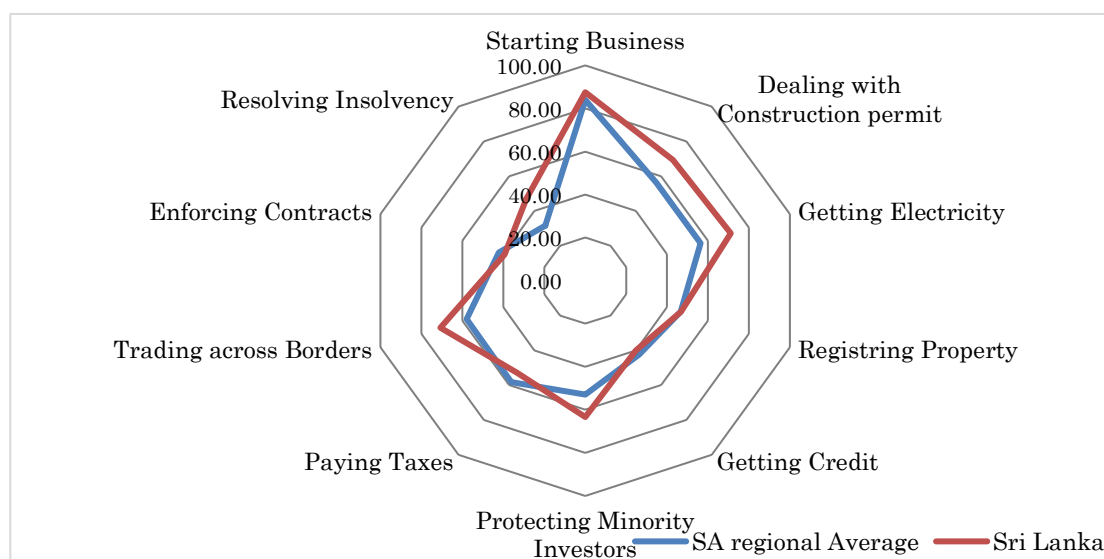


Figure 3-6 Sri Lanka’s Business Score by the World Bank

Source: Survey team based on Doing Business 2017, World Bank

⁴⁷ DTF: Distance to frontier

Figure 3-5 compares Sri Lanka's scoring with regional (South Asia) average. South Asia's average point is 52.87% and average ranking is 132, hence, Sri Lanka presents better business environment than other neighbouring countries. Sri Lanka has not yet exceeded regional average in three aspects which are "Getting Credit", "Paying Taxes" and "Enforcing Contracts". While there were indicators exceeding regional averages; "Dealing with Construction Permits", "Getting Electricity", "Protecting Minority Investors", "Trading across Borders" and "Resolving Insolvency". Two indicators, "Starting Business" and "Registering Property", are equal or almost equal to the regional average. Normative actions are evaluated as weak, however, business development areas in "Starting a Business" and "Protecting Minority Investors" improved from the previous year to 21 and 9 ranks respectively.

Well-regarded improvements in "Starting Business" and "Minority Investors' protections" are abolishing stamp duty, and stipulating board or shareholder approvals for related-party transactions.

To improve the situation, the WB has provided advisory services to improve the business climate of Sri Lanka and they include ① investment promotion, ② improvement of business environment, ③ investment-related laws, ④ investment incentives and ⑤ OSS. All projects have achievement goals of improving the appraisal rank by 10 on DB indicators and support is provided.

3.4.2 Appraisal based on Policy Framework for Investment

The Policy Framework for Investment (PFI) by Organisation for Economic Co-operation and Development (OECD) provides a checklist of key policy issues for governments intending to; create attractive investment climate for investors, spread benefits of development investment in the society, particularly among the poor, and aims to promote the UN Monterey Consensus that claims the importance of private investment for effective implementation of development strategies.

It provides tools of policy appraisal for national governments to improve the investment climate.

Analysis criteria

1. Investment Policy
2. Investment Promotion and Facilitation
3. Trade Policy
4. Competition Policy
5. Tax Policy
6. Corporate Governance
7. Policies for Promoting Responsible Business Conduct
8. Human Resource Development
9. Infrastructure and Financial Sector Development
10. Public Governance

The PFI appraisal points and Sri Lankan situations against them are stated in the next section.

(1) Investment policy

The quality of investment policy directly affects investors' decision-making regardless of the scale of investment or in or outside the country. Transparency, assets protection and non-discrimination are principles of investment policy and they support the efforts of creating sound investment conditions for everyone. ⁴⁸

Table 3-21 PFI Analysis: Investment Policy
(○ = policy is straightened; Δ policy is there but insufficient; and ×= no policy is available)

| Questions | Current status of Sri Lanka |
|--|--|
| 1.1 What steps has the government taken to ensure that the laws and regulations dealing with investments and investors, including small and medium sized enterprises, and their implementation and enforcement are clear, transparent, readily accessible and do not impose unnecessary burdens? | Δ: Although the process of legislation has been established, there are problems under Sri Lankan practice to secure its national financial resources such as sudden policy change without formal procedures. This creates high unpredictability. |
| 1.2 What steps has the government taken towards the progressive establishment of timely, secure and effective methods of ownership registration for land and other forms of property? | Δ: Enterprises considering investment can use export processing zones and industrial parks managed by the BOI, and can also use the Land Bank. Meanwhile, a law prohibiting land ownership by foreign nationals and foreign investors was established in 2014, creating uncertainty. |
| 1.3 Has the government implemented laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms? Does the level of protection encourage innovation and investment by domestic and foreign firms? What steps has the government taken to develop strategies, policies and programs to meet the intellectual property needs of SMEs? | ○: The Intellectual Property Act (No.36 of 2003) contains a series of detailed provisions in the field of intellectual property rights. In addition, Sri Lanka has ratified the Trade Related Aspects of Intellectual Property Rights (TRIPS) Convention, and the WTO has finished investigation on Sri Lankas domestic bills necessary for implementation. Since Sri Lanka leans heavily towards import, the inflow of IP (Intellectual Property) infringement products is unavoidable. To prevent the inflow of IP infringement products, education for regulators such as customs, police are necessary in addition to the notifying activities for consumers. For infringement products manufactured within Sri Lanka, an education and promotion of intellectual right protection shall be encouraged to individual industries. ⁴⁹ |
| 1.4 Is the system of contract enforcement effective and widely accessible to all investors? What alternative systems | Δ : Commercial arbitration court is established within the supreme court, however the number of arbitration judges |

⁴⁸ Policy Framework for Investment, OECD, 2017

⁴⁹ Above note based on interview to the National Intellectual Property Office and legal firm with an intellectual right protection practices. Both organization suggested the intellectual right protection in Sri Lanka is largely focused on exposure of illegally imported products, and its importers. The responsibility of illegal IP goods shall be bored by the production country.

| Questions | Current status of Sri Lanka |
|--|--|
| of dispute settlement has the government established to ensure the widest possible scope of protection at a reasonable cost? | especially with experience in international arbitration is lacking. |
| 1.5 Does the government maintain a policy of timely, adequate, and effective compensation for expropriation also consistent with its obligations under international law? What explicit and well-defined limits on the ability to expropriate has the government established? What independent channels exist for reviewing the exercise of this power or for contesting it? | ×: Based on the Revival of Underperforming Enterprises or underutilized Assets Act, there are cases where the Sri Lankan government or a government agency expropriate certain assets. |
| 1.6 Has the government taken steps to establish non-discrimination as a general principle underpinning laws and regulations governing investment? In the exercise of its right to regulate and to deliver public services, does the government have mechanisms in place to ensure transparency of remaining discriminatory restrictions on international investment and to periodically review their costs against their intended public purpose? Has the government reviewed restrictions affecting the free transfer of capital and profits and their effect on attracting international investment? | ○: 100% ownership of foreign capital is permitted except for certain fields. Investors can remit 100% of revenue, remuneration and capital to their home country, and they can freely make foreign exchange transactions. |
| 1.7 Are investment policy authorities working with their counterparts in other economies to expand international treaties on the promotion and protection of investment? Has the government reviewed existing international treaties and commitments periodically to determine whether their provisions create a more attractive environment for investment? What measures exist to ensure effective compliance with the country's commitments under its international investment agreements? | ○: Sri Lanka has signed a bilateral investment agreement (IPA) and a double taxation prevention treaty (DTAA), and is actively working to protect investors. |
| 1.8 Has the government ratified and implemented binding international arbitration instruments for the settlement of investment disputes? | ○: In addition to independent courts, Sri Lanka is promoting the bilateral investment agreement (IPA), the double taxation prevention treaty (DTAA), and it is a member of the Multilateral Investment Guarantee Agency (MIGA). It is also developing a preventive mechanism against confiscation and non-commercial risk. |

Source: Survey team based on OECD Policy Framework for Investment

Although the legal framework is being straightened under the Sri Lankan investment policy, there is a gap in terms of their use and transparency. As the PFI has a strong aspect of questioning the availability of legal framework, the item ranked low in the above is only “1.5 government expropriation measure”. However, to push effectiveness, revision is needed on “1.1 legal regulations on investment environment demand” since comments from investors noted that there are needs to improve clarity and transparency of government practices and avoid unnecessary burdens. With respect to the resolution of commercial disputes, the DB indicators states that Sri Lanka remains ranked 163rd out of 189 countries in 2016 and 2017⁵⁰. As for the time required for resolution, it takes as long as 1,318 days, which is longer than the average number of days in South Asia (1,077 days). Such status gives rise to investors’ concerns for smooth execution of business.

(2) Investment promotion and facilitation

Investment promotion and facilitation measures, such as incentives, may work effectively to attract investment if they are aimed at correcting market failures and developed to leverage the advantages of the investment environment of each country.

Table 3-22 PFI Analysis: Investment Promotion and Facilitation
 (○ = policy is straightened; Δ policy is there but insufficient; and ×= no policy is available)

| Description of evaluation items | Current status of Sri Lanka in relation to the analysis criteria |
|--|--|
| 2.1 Does the government have a strategy for developing a sound, broad-based business environment and within this strategy, what role is given to investment promotion and facilitation measures? | Δ: Although the importance of FDI has been referred to and priority sectors for investment attraction have been set up centred on the six-hub initiatives of the previous administration, (commerce, tourism, aviation, energy, knowledge, maritime transportation), specific investment promotion sectors and strategies are unclear. Currently, with the assistance of Harvard University and the World Bank, a study to narrow down the sectors to attract investment is being implemented. The study aims to convert target industries of export promotion by the EDB based on an action plan with activities of the BOI for investment promotion. The trade policy under revision focuses on export expansion and product/market diversification. FDI, puts weight on the attraction of export-oriented companies and companies earning foreign currency. |
| 2.2 Has the government established an investment promotion agency (IPA)? To what extent has the structure, mission, and | ○: Although it has not clearly benchmark other organizations, the BOI has a history of about 40 years (from |

⁵⁰ See Doing Business results of WB (<http://www.doingbusiness.org/data/exploreconomies/sri-lanka>).

| Description of evaluation items | Current status of Sri Lanka in relation to the analysis criteria |
|---|--|
| legal status of the IPA been informed by and benchmarked against international good practices? | the establishment of its predecessor) and has accumulated track records, such as contributing to the settlement of apparel industry in Sri Lanka. It assumes a core role in promoting FDI in Sri Lanka. |
| 2.3 Is the IPA adequately funded and is its performance in terms of attracting investment regularly reviewed? What indicators have been established for monitoring the performance of the agency? | △: Clear objectives of the activities, as represented by the KPI, have not been established. An organizational action plan is developed and reviewed annually. Because it is a large organization with nearly 1,200 employees across the country, it is currently working to restructure the organization, receiving feedback from donor organizations. |
| 2.4 How has the government sought to streamline administrative procedures to quicken and to reduce the cost of establishing a new investment? In its capacity as a facilitator for investors, does the IPA take full advantage of information on the problems encountered from established investors? | ○: It is working to simplify the administrative procedures by incorporating the OSS. Also, it is trying to take a proactive approach in facilitating investment by setting up a high-level conference body to resolve the delay in approvals by line ministries, which is a bottleneck in the approval process. |
| 2.5 To what extent does the IPA promote and maintain dialogue mechanisms with investors? Does the government consult with the IPA on matters having an impact on investment? | △: The BOI recognizes that the improvement of investment environment is important for attracting FDI and the Research & Policy Advocacy Department is in charge of communication in this regard. With respect to challenges faced by Japanese companies, challenges of investors are grasped through such opportunities as the joint forum of public and private sectors, but it takes time to improve the situation to resolve such challenges. The Monitoring Department of the BOI carries out periodic communication with investors, but currently, the communication does not go beyond scrutiny of investor's business activities. |
| 2.6 What mechanisms has the government established for the evaluation of the costs and benefits of investment incentives, their appropriate duration, their transparency, and their impact on the economic interests of other countries? | ×: It has become obvious that generous incentives excessively granted in the past have imposed a burden on the national finance. As a reaction against this, currently, a tax holiday is not granted to new investors, which makes a negative impact on investment attraction. |
| 2.7 What steps has the government taken to promote investment linkages between businesses, especially between foreign affiliates and local enterprises? What measures has the government put in place to address the specific | △: The BOI carries out activities such as dispatch of overseas missions and hosting of missions from other countries. It also performs business matching from time to time, but successful cases are only a few. Private consulting |

| Description of evaluation items | Current status of Sri Lanka in relation to the analysis criteria |
|--|---|
| investment obstacles faced by SMEs? | firms are more active in conducting such activities. |
| 2.8 Has the government made use of international and regional initiatives aimed at building investment promotion expertise, such as those offered by the World Bank and other intergovernmental organisations? Has the IPA joined regional and international networks? | ○: Efforts have been made to utilize the results of World Bank projects and actively incorporate insights of external organizations, such as Harvard University, McKinsey & Company, Inc. and A.T. Kearney. |
| 2.9 To what extent has the government taken advantage of information exchange networks for promoting investment? | ○: Cooperative relationship with UNCTAD and WTO has been established by participating in international agreements, such as agreement to bilateral investments and FTA. |

Source: Survey team

The Sri Lankan government is aware of the importance of FDI and is driving the initiatives to establish schemes to increase the investments by foreign investors, while receiving assistance from donor organizations and other foreign organizations. However, from the current status of the government where the de facto requirement of minimum investment for investor qualification and no prior notice on announcements regarding foreign investors leaves issues in government system to invite foreign direct investment. There is a lack of consistency in the government. According to the results of investor surveys⁵¹, inconsistency in policy is ranked high among the issues pointed out by investors. This comes from the anxiety among investors against the government policy lacking clear statement on the direction and timeline of national economic development.

(3) Trade policy

The policy on trade of goods and services can support higher-quality investment through expanding the opportunities to enjoy the benefit from economy of scale, promoting integration in international supply chain, and increasing productivity and return on investment.

⁵¹ See “The Global Competitiveness Report 2016-2017 (2016, World Economic Forum)” and “Japan-Sri Lanka Business Needs Survey (2013, JETRO)” as examples.

Table 3-23 PFI Analysis: Trade Policy
(○ = policy is straightened; Δ policy is there but insufficient; and ×= no policy is available)

| Questions | Current status of Sri Lanka |
|--|--|
| 3.1 What recent efforts has the government undertaken to reduce the compliance costs of customs, regulatory and administrative procedures at the border? | ○ : Legal system to implement Category B and C of the WTO rules by 2018 is being considered. Some criteria of category B is already being implemented customary within the organization. |
| 3.2 What steps has the government taken to reduce trade policy uncertainty and to increase trade policy predictability for investors? Are investors and other interested parties consulted on planned changes to trade policy? | ○ : Discussion among the Ministry of Development Strategies and International Development and relative organizations are not necessarily comprehensive, unable to compensate investor opinion. |
| 3.3 How actively is the government increasing investment opportunities through market-expanding international trade agreements and through the implementation of its WTO commitments? | ○: Sri Lanka positions exports as a means of acquiring foreign currency, and is actively engaged through joining to the WTO. Also strengthening regional cooperation with neighbouring countries by concluding FTAs with countries with deep economic relations such as China. |
| 3.4 How are trade policies that favour investment in some industries and discourage it in others reviewed with a view to reducing the costs associated with these distortions? | Δ : Discussion held among the Ministry of Development Strategies and International Trade and the EDB to avoid disadvantages from trade policies. |
| 3.5 To what extent do trade policies raise the cost of inputs of goods and services, thereby discouraging investment in industries that depend upon sourcing at competitive world prices? | △: Since Sri Lanka does not have a clear trade policy at present, we cannot make a decision on this item. Cooperation between its investment policy and trade policy is unclear. |
| 3.6 If a country's trade policy has a negative effect on developing country exports, what alternative means of accomplishing public policy objectives has the government considered, taking into account the dampening effect that such a restrictive trade policy also has on investment? | ○: Although Sri Lanka does not have a clear trade policy at present, EDB utilizes its action plans to identify priority industries and promote export expansion. |
| 3.7 To what extent does trade policy support and attract investment through measures that address sectoral weaknesses in developing countries (e.g. export finance and import insurance)? | ○: Although Sri Lanka does not have a clear trade policy at present, EDB utilizes its action plans to identify priority industries and promote export expansion. |

Source: Survey team based on OECD Policy Framework for Investment

EDB is encouraging export promotion, whilst in the meantime, lack of information and opinion sharing among government agencies and the stakeholders could be seen. Specifically, evaluation on items 3.1 including customs procedures and tariff application, or 3.2 including measures to reduce uncertainty related to trade policy and increase predictability for investors, highlighted the difference in opinion.

(4) Corporate governance

To what degree companies comply with the basic principle of sound corporate governance affects investment decision, as well as trust of investors, capital cost and functionality of entire finance market and the establishment of sustainable fund acquisition approach in the end. Questions in Table 3-25 provide overview of main issues of corporate governance to be solved by responsible ministries and agencies, to promote good investment conditions. More accurate appraisal requires them to use the OECD principle of corporate governance and appraisal method, developed by the corporate governance group as reference. In addition, when possible, they can request the WB to conduct appraisal based on the report in compliance with international standards of corporate governance.

Table 3-24 PFI Analysis: Corporate Governance

(○ = policy is straightened; Δ policy is there but insufficient; and ×= no policy is available)

| Questions | Current status of Sri Lanka |
|--|--|
| 6.1 What steps have been taken to ensure the basis for a corporate governance framework that promotes overall economic performance and transparent and efficient markets? Has this been translated into a coherent and consistent regulatory framework, backed by effective enforcement? | Δ : Sri Lankan stock market and the Institute of Chartered Accountants of Sri Lanka are referring to various principles including the OECDs “Principles of Corporate Governance Code”. |
| 6.2 How does the corporate governance framework ensure the equitable treatment of shareholders? | ○ : There is no distinction between domestic and foreign investors. The rights of shareholders are institutionally stipulated under the Corporate Law. |
| 6.3 What are the procedures and institutional structures for legal redress in cases of violation of shareholder rights? Do they function as a credible deterrent to such violations? What measures are in place to monitor and prevent corporate insiders and controlling owners from extracting private benefits? | ○ : There is no distinction between domestic and foreign investors. The rights of shareholders are institutionally stipulated under the Corporate Law. |
| 6.4 What procedures and institutions are in place to ensure that shareholders have the ability to influence significantly the company? | ○ : The rights of shareholders are institutionally stipulated under the Corporate Law. |
| 6.5 By what standards and procedures do companies meet the market demand for timely, reliable and relevant disclosure, including information about the company’s ownership and control structure? | ○ : Companies must prepare accounting books and closing accounts. Depending on the business form, companies are obliged to undergo financial audits. |
| 6.6 How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable to the company and its shareholders? Does the framework also recognise the rights of stakeholders | Δ : Principally, Companies Act, No.7 of 2007 states the role of board players and governance system in Sri Lanka, information to be disclosed. Additionally the Institute of Chartered Accountants of Sri Lanka appointed the Code of Best Practice of Corporate Governance 2013, noting |

| Questions | Current status of Sri Lanka |
|---|--|
| established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises? | global best practices and issues in governance, recommended for companies. Section D of the code determines the responsibility of board players, role of internal audit, audit committee, financial disclosure requirements, code of conduct, and corporate governance in financial reporting. |
| 6.7 What has been done, and what more should be done in terms of voluntary initiatives and training to encourage and develop a good corporate governance culture in the private sector? | Δ : Awareness reform on governance among listed companies are conducted, but the frequent change in board members due to corruption states the need for continuous awareness change. |
| 6.8 Has a review been undertaken of the national corporate governance system against the OECD Principles of Corporate Governance? Has the result of that review been made public? | ○ : Corporate Governance Code referred by the SEC is the OECD principle. |
| 6.9 How is the ownership function of state-owned enterprises (SOEs) structured to ensure a level playing field, competitive market conditions, and independent regulation? What are the processes in place to ensure the state does not interfere in day-to-day management of SOEs and that board members may effectively carry out their role of strategic oversight, rather than to serve as a conduit for undue political pressure? How SOEs are effectively held accountable to the government, the public, and to other shareholders (if any)? | × : Corporate governance environment for SOEs is undeveloped. Especially lack of consideration to protect the beneficiary of the citizens among board members at times of political pressure. |

Source: Survey team based on OECD Policy Framework for Investment

Efforts related to corporate governance are made in the country particularly at the level of prevention of corruption. However, although efforts are made from the perspective of SCM by international companies (clothing and sewing companies) on the rules of protection of shareholders (6.3) and information disclosure (6.5) assumed by PFI, issues among governance in the public sector and separation of state owned companies and politics in 6.8 and 6.9 are unknown.

3.4.3 Current status of policy actions of DPL

JICA in collaboration with the World Bank (WB) signed a loan agreement, "Development Policy Loans (Private sector development, Governance improvement, and Fiscal Consolidation)" in October 2016, which provides financial support based on the achievement of the target of policy actions. The government of Sri Lanka is in need of financial support to improve the budget situation, and it also needs appropriate policy actions for "Private sector development", "Governance improvement" and "Fiscal consolidation" to stabilize its budget balance. The current status of each policy actions are as follows.

Regarding the "Private sector development", National Trade Facilitation Committee (NTFC) has been

already established and the action plan is under preparation at time of this survey for the item of “Trade facilitation”. As to the “Removing obstacles to foreign investment”, One Stop Shop (OSS) has been established in BOI. Concerning “Enhancing access to finance”, a new secured transaction act is now under review in the cabinet.

Table 3-25 Improving private sector development (Private sector competitiveness)

| Areas of Intervention | Policy Actions | Indicator | Current status of the policy actions (As of June 2017) |
|--|---|---|--|
| Increasing the efficiency of trade facilitation | The Government of Sri Lanka has: (a) ratified the Protocol annexing the World Trade Organization Trade Facilitation Agreement to the WTO Agreement; and (b) created a National Trade Facilitation Committee (NCTF). | Adoption of national action plan for the implementation of the WTO Trade Facilitation Agreement including specific roles and responsibilities, timeframe for implementation, and required human and financial resources | National Trade Facilitation Committee (NTFC) was formed with the support of the World Bank. The action plan is under preparation as of June 2017 |
| Removing obstacles to foreign investment entry and establishment | The Cabinet of Ministers has approved the establishment of an one - stop - shop (OSS) for foreign investors aimed at reducing the processing time for investment approval. | Increasing the efficiency of trade facilitation Average time required for foreign investment approval (Baseline: 63 days on average Target: 50 days on average) | OSS was established in BOI. However, the World Bank considered that the OSS is not effective without clear objectives and KPI. |
| Enhancing access to finance | The Cabinet of Ministers has authorized the drafting of a new Secured Transactions Bill that will include provisions to facilitate the use of movable assets as collateral for bank loans, and to repeal the Secured Transactions Act 49 of 2009. | Enactment of the new Secured Transactions Act repealing the Secured Transactions Act 49 of 2009, facilitating the use of movable assets as collateral for bank loans | The new Secured Transactions Act is now under review in the Cabinet. |

Source: Table prepared by Survey team

Regarding the “Governance improvement”, the Right to Information Act has come into force already. In the meantime, as to the “Strengthening audit oversight”, the final version of the National Audit Bill awaiting submission to the Parliament. Concerning “Strengthening Public Finance Management”, Public Finance Act is awaiting submission to the Parliament yet.

Table 3-26 Governance improvement (Enhancing transparency and public sector management)

| Areas of Intervention | Policy Actions | Indicator | Current status of the policy actions (As of June 2017) |
|---|--|---|--|
| Establishing a Right to Information Framework | The Government of Sri Lanka submitted to Parliament a Right to Information (RTI) Bill | Share of ministries that proactively disclose information as required by the RTI Act on websites. (Baseline: 0%, Target: 50%) | <ul style="list-style-type: none"> The Right to Information Act came into force in August 2016. The World Bank regarded that the target was achieved as of June 2017. |
| Strengthening Audit Oversight | The National Audit Bill has been submitted to the Cabinet of Ministers. | Establishment of a National Audit Office with administrative and financial independence. | <ul style="list-style-type: none"> The final version of the National Audit Bill remains under discussion in the Cabinet. As a result, the National Audit Office planned in the draft of the bill is yet to be established |
| Strengthening Public Financial Management | The Cabinet of Ministers has authorized the MOF to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises. | Submission of Public Finance Act to Parliament. | <ul style="list-style-type: none"> Public Finance Act is not submitted to Parliament yet as of June 2016. The draft of the bill is under review in the MOF. |

Source: Table prepared by Survey team

Regarding “Fiscal Consolidation”, though no legislation has been enacted to abolish the Strategic Development Act, no new projects with associated tax incentives is approved under the Act since January 2016. Meanwhile, “Increasing the efficiency of debt management”, the Debt Management Unit is still under development and the Medium-Term Debt Management Strategy has not been published

Table 3-27 Fiscal Consolidation (Improving fiscal sustainability)

| Areas of Intervention | Policy Actions | Indicator | Current status of the policy actions (As of June 2017) |
|--|---|--|---|
| Reducing granting of new tax holidays and clarifying | The Cabinet of Ministers has decided to submit to Parliament a proposal to repeal the Strategic | No new projects with associated tax incentives approved under SDP Act. | <ul style="list-style-type: none"> No legislation has been enacted to abolish the Act. As of 2016. No further projects are currently being approved except the One |

| Areas of Intervention | Policy Actions | Indicator | Current status of the policy actions (As of June 2017) |
|--|---|--|--|
| investment regime | Development Project Act of 2008. | | Colombo Project and the Port City Project which were identified in 2014. |
| Increasing the efficiency of debt management | The Cabinet of Ministers has approved setting up a debt management unit in the MOF. | Approval and publication of a medium term debt management strategy (MTDS) covering domestic and external debt and defining measures to develop the domestic debt market. | • The Debt Management Unit has not yet been created. Consequently, the Medium-Term Debt Management Strategy has not been published |

Source: Table prepared by Survey team

3.5 Issues related to investment-related laws

3.5.1 Organizational issues

(1) Issues within BOI

The BOI has successfully helped growth of clothing sector and contributed to solving national problems since its establishment in 1978 and its activities are not conducted with other investment promotion agencies as its benchmark⁵². According to BOI's investment advisor from JICA, the BOI did not need proactive measures to increase investments because of the demand for the post-civil war recovery and the honey-moon relationship with China. Although, BOI is now facing the situation that they need to change their passive stance.

According to the interview with companies that established business there, the OSS is not sufficiently functioning as an integrated contact point. For example, up to 65 to 70 administrative processes are needed for investors to obtain BOI approval. BOI negotiates individually with relevant ministries and receives documents and information, but unfortunately this is not helping to shorten the duration to obtain investment approval. It was pointed out that the procedures of starting a business are complicated, that there are many relevant organizations and thus it hinders acceleration of BOI investment process⁵³. It cannot be denied that Sri Lankan administrative procedures take time in general and the implementation of One-Stop Shop, shall improve the legal system in general and reduce required time for registration of business start-ups. It requires around 10 days for application in reserving the business name at the ROC under the current Companies Act, which is to be shortened through simplification.

Currently, provision of the OSS service has not helped in reducing the time required for investment approval. It takes an average of three to four weeks to conclude an agreement with the BOI, and it is also necessary to obtain approvals from line ministries which also require additional time. As a result, the process from the application to the conclusion of agreement with the BOI as an approved company requires about

⁵² According to interview BOI's Investment Promotion Department.

⁵³ According to interview with a Sri Lankan law firm

100 days on the average⁵⁴. A representative of the local office of the World Bank considers that the current OSS does not have a clear purpose of existence, does not fulfil its substantial functions and is inadequate in terms of service provision to investors. More specifically, problems raised by the World Bank are: 1) The OSS does not demonstrate its role as a centralized contact point because, from the investors point of view, the BOI has multiple entry points other than the OSS, 2) After the BOI has expansion, it has become unclear whether it is an organization for facilitation or an organization for granting approval, and 3) Inquiries from investors are not promptly responded to, and as such, there is room for improvement in the approach to service provision. In addition, the World Bank is concerned that establishment of two committees to reinforce the procedures for investment approval (SWIAC and IAFC) by the Sri Lankan government, may accept exceptional procedures outside the existing investment approval system. While the time required for obtaining approval from line ministries is currently an issue, the World Bank considers that the lack of leadership and sense of urgency within the BOI to expedite the investor approval process is a problem⁵⁵.

Furthermore, some comments on the slow function of the OSS were retrieved from the investors. For example, the Project Monitoring Section is not processing the facilitation as expected⁵⁶, and there are lack of expertise among BOI and responsible ministries on business structures, as a result, taking more time⁵⁷. Investors need accurate and latest legal information such as incorporation, taxation and accounting, labour, land, import and export. However, since the BOI currently does not have a specialized section to collect such information and provide it to investors, investors have no choice but to search information sources on the government websites⁵⁸. Also, as this survey has revealed, since the system change is frequent and unpredictable, it is not clearly indicated what standard is applied and as such, information required for investors to engage in business activities is unclear.

Moreover, with respect to the assistance after the start of business, currently, the Monitoring Department only verifies the activity status of BOI companies, and does not have a structure to encourage reinvestment. Considering the current situation where the incentives to bring in new investments are limited, it is important to settle the existing companies invested and call for new investments in Sri Lanka.

⁵⁴ According to interview with BOI' Investment Promotion Department

⁵⁵ According to interview with the World Bank.

⁵⁶ According to interview with A Japanese apparel parts manufacturer. According to him, the BOI does not provide proactive aftercare assistance although it consults on new facility investment, etc. as needed. Although they say it provides OSS, companies are usually sent from one relevant agency to another and it is merely an agency that accepts necessary documents. A Japanese bank in Sri Lanka pointed out that the BOI is bloated and bureaucratic and their aftercare for companies that have entered the country is insufficient. CEO of a Japanese automobile parts manufacturer pointed out that it does not have KPI and it may not properly understand what investors want.

⁵⁷ According to a Japanese manufacturer, chemical product processing industry does not have a long history in Sri Lanka and thus they have HR shortage, which required time to have understanding of supervising ministries including OSS staff for the company to obtain permit for manufacturing and import of chemical products that are raw materials. According to another Japanese manufacturer, customs staff misunderstood that the company sells alcohol when it was going to import it for industrial use it uses in the manufacturing process and they were almost going to impose more tariff than ordinary import tariff.

⁵⁸ For example, on the BOI website, "Land (Restrictions on Alienation) Act No. 38 of 2014" remains available for viewing. However, an amendment to this Act was publicly announced on February 23, 2017. Also, although the government will not grant a tax holiday as stipulated in Gazette 1469/35 in the future, the Gazette is still available on the website, which may cause misunderstanding.

(2) Relationship between BOI and other organizations

It was pointed out that the BOI has the abovementioned issues partly because there are multiple investment promotion organizations and BOI's role is unclear. Under the current administration, the BOI does not have the decision-making power and thus is involved in bargaining among ministries, although it externally serves as the contact point as an investment promotion agency. As a result, it needs to coordinate various procedures and arrangements for approval, and the outcome is not what investors expect.

3.5.2 Operational issues

(1) Uncertainty of legal interpretation

Another major issue in tax law, is that legal interpretations by responsible officials of public authorities vary. Even when taxpayers submit tax deduction application forms, they may be assessed as unqualified depending on the officers' interpretation of the IRA.

Following is an example case of Article 7, the VAT Act Zero rating (1) (c).

“any other service, being a service not referred to in paragraph (b), provided by any person in Sri Lanka to another person outside Sri Lanka to be **consumed** or utilised outside Sri Lanka shall be zero rated provided that the payment for such services in full has been received in foreign currency from outside Sri Lanka through a bank in Sri Lanka.” (The boldfaced underline added by Survey team.)

Whether the VAT tax rate on the service⁵⁹ provided by a company in Sri Lanka should be 0% or 15%, depends on the interpretation of the where a service was *consumed*. For example, if there was an order from another company in Sri Lanka to survey a market in a foreign country and prepare a survey report, the service includes both investigation service performed in the foreign country, and service performed in Sri Lanka. In cases as such where exact consideration of work location are not decided among contract, the interpretation of the article might be a problem.

The IRD has no comprehensive guidance that explains in detail, all clauses of tax laws for interpretation, causing confusion to foreign and local companies.

Although taxpayers can consult with the tax office before the end of the financial year, in most cases, interpretation tend to make taxation as heavy as possible, making companies reluctant to consult with the tax office.

(2) Insufficient public notice on tax information

Although the MOF claims that the public notice of the budget speech enables tax information known widely, it is not easy for general taxpayers to correctly understand it and apply it correspondingly.

The tax office in Sri Lanka organizes regular seminar sessions on tax issues, but the office should increase

⁵⁹ Services directly connected with any movable or immovable property outside Sri Lanka, the repair of any foreign ship or aircraft, computer software development, client support services provided over the internet or the telephone to one or more identified client outside Sri Lanka, or the provision of services to overseas buyers by a garment buying office registered with the Textile Quota Board shall be zero rated based on Article 7(1) (b). Article 7(1) (c) refers services not referred to in (b).

seminar sessions on tax issues related to foreign investors

Although tax laws and their application procedures are summarized on the website of the IRD, it does not provide comprehensive practical guidelines to cover almost all specific individual cases.

There is no periodical publication on accounting or taxes that is subscribed widely in Sri Lanka, and only few tax seminars by accounting firms are held in Sri Lanka. Even investors need latest and accurate tax related information, it may be difficult. Therefore, in line with the increase in foreign investors and domestic clients, Sri Lankan accounting firms and publishers are expected to expand information provision through seminars and publications.

Under such circumstances, companies are not fully aware of latest tax-related information that includes interpretation of laws.

(3) Pending refund of excess input VAT

The issue on tax refund had been raised numerous times throughout this survey and also in the past government-private joint forum between Sri Lanka and Japan. In particular, it has been a problem when withdrawing after completion of the project or liquidating a local subsidiary in Sri Lanka.

In principle, the IRD will not refund any excess input VAT on the proposed business, and the excess can be carried forward for it to be set off against future periods. However, if any person registered under the section 22(7) of the VAT act, any amount of VAT paid on purchases of goods or services can be claimed as a refund before commencing its commercial operation (during the project implementation period) even if there is no output. In order to issue VAT refunds without unnecessary delays, above persons should comply with the necessary procedures such as filing VAT returns, and the IRD will review them to proceed refund.

And if a registered person is unable to make a claim due to death, incapacity, bankruptcy, liquidation or other cause, his executor, trustee or receiver as the case may be, is entitled to a refund of any tax (section 58A(2) of the VAT act).

Therefore, it is necessary to pay attention to submit application to register under the section 22(7) of the VAT act, as stated above before, commencing its operation in order to receive the VAT refund.

On the other hand, section 71 of the VAT act stipulates establishment of the Value Added Tax Refund Fund. A part of VAT collection (10% before January 1, 2014 and 6% after January 1, 2014) has been credited to the fund. Although the fund is legislated for VAT refund, there are possibilities that the IRD will hesitate large scale VAT refunds due to financial difficulties of the Sri Lankan government.

From interviews to a local accounting and taxation specialist, the reasons of delay of VAT refunds are not only due to financial difficulties of the government, but also delay of procedures to review applications and attached documents to VAT refund. In general, time lags between applications and VAT refunds are several months. However, sometimes the time lag could become several years. The reasons could be that the succession between IRD officials was unsuccessful, or a part of attached documents such as an invoice was lost, so the application was neglected for several years.

The issue of excess input VAT not being refunded for many years may be attributed to ① financial difficulties of the government, ② delay of VAT refund application review procedures by the IRD, or ③ the enterprise forgetting to submit a necessary document. For ②, it is preferable that the IRD will improve

procedures related to VAT refund. For ③, IRD could disclose necessary procedures in an exhaustive and easy-to-understand manner so that companies could correctly understand tax regulations necessary to perform business in Sri Lanka.

3.6 Major infrastructure development

The Government of Sri Lanka claims that infrastructure development that contributes to business activities should be conducted intensively in such scheme as PIP, since road and other infrastructure helps increase productivity and contributes to increase of export.

The development of major infrastructure is a key factor when companies make investment decisions. It has an impact on various issues—it significantly affects their business cost, and physical connect ability to logistics infrastructure indicates integration as a single market, or the connect ability of the supply chain in the progress of regional economic integration. Following table show the characteristics in general that are observed, of infrastructure conditions investors pay attention to, when they decide their investment destination.

Table 3-28 Required infrastructure development by types of industry/business
(⊙ - Extremely important, ○ - Important)

| | Manufacturing (Manufacturing site) | Manufacturing (Sales site) | Logistics | Communication/IT |
|---------------------------|---------------------------------------|-------------------------------|-----------|------------------|
| Electricity | ⊙ | ○ | ○ | ⊙ |
| Logistics (Roads) | ⊙ | ⊙ | ⊙ | ○ |
| Logistics (Ports) | ⊙ | ⊙ | ⊙ | |
| Logistics (Airports) | ⊙ | ⊙ | ⊙ | |
| Communication environment | ⊙ | | | ⊙ |
| Service water | ○ | | | |
| Land | ○ | | ○ | |
| Warehousing | ○ | | ○ | |

Source: Prepared by Survey team

Table 3-29 provides a comparison of the evaluation of the quality of major infrastructure between Sri Lanka and major South Asian countries such as Thailand and Vietnam in the Association of South-East Asian Nations (ASEAN), based on the report on competitiveness produced by the World Economic Forum.

Table 3-29 Comparison of infrastructure among major South Asian countries and ASEAN countries

| | Sri Lanka | | India | Bangladesh | Pakistan | Thailand | Vietnam |
|------------------------------------|-----------|------|-------|------------|----------|----------|---------|
| | Score | Rank | Score | Score | Score | Score | Score |
| Infrastructure (Overall) | 4.4 | 55 | 4.5 | 2.8 | 3.5 | 4.0 | 3.6 |
| Quality of Road | 4.7 | 43 | 4.4 | 2.9 | 3.8 | 4.2 | 3.5 |
| Quality of railroad infrastructure | 3.6 | 43 | 4.5 | 2.7 | 3.1 | 2.5 | 3.1 |
| Quality of port infrastructure | 4.3 | 60 | 4.5 | 3.5 | 3.7 | 4.2 | 3.8 |
| Quality of air transport | 4.6 | 58 | 4.5 | 3.2 | 4.0 | 5.0 | 4.1 |

| | Sri Lanka | | India | Bangladesh | Pakistan | Thailand | Vietnam |
|---|-----------|------|-------|------------|----------|----------|---------|
| | Score | Rank | Score | Score | Score | Score | Score |
| infrastructure | | | | | | | |
| Quality of electricity supply | 4.4 | 83 | 4.3 | 3.2 | 2.4 | 5.1 | 4.4 |
| Mobile-cellular telephone subscriptions /100 pop. | 112.8 | 78 | 78.8 | 83.4 | 66.9 | 125.8 | 130.6 |
| Fixed-telephone lines /100 pop. | 12 | 77 | 2.0 | 0.5 | 1.6 | 7.9 | 6.3 |

Note: Score represents an average of scale ranging from 1 to 7. Rank out of 138 economies

Source: World Economic Forum, The Global Competitiveness Report 2016 – 2017

According to the scores above, the quality of infrastructure of Sri Lanka is almost at the same level as that of India, excluding railways, and higher in general than that of Pakistan or Bangladesh. When compared with Thailand, Sri Lanka received higher scores, although only slightly, and they did not include electric power supply and air transportation. When compared with Vietnam, Sri Lanka has received higher scores on infrastructures, and same score for electric power supply. Telecommunication subscription is at the same level as Thailand and Vietnam in the ASEAN.

The following section summarizes the current situation with focus on transportation, electricity and telecommunications sectors that were indicated as important in promoting investment by the Government of Sri Lanka and local companies in the field survey conducted in February and April 2017.

3.6.1 Transportation

In the interviews conducted during the survey, private companies expressed their strong improvement needs, especially for roads, railways and ports in the transportation sector, which play important roles in corporate production and export activities. Listed below are the major issues in the sector mentioned in the interviews.

- Due to population concentration in areas such as Colombo, Kandy, traffic congestion has become heavier in urban areas.
- With an increasing number of automobiles, use of fossil fuels is growing and environmental loads are increasing.
- There is room for improvement in connection among different modalities such as bus and railway.

The current state of roads, railways and ports are summarized as below.

(1) Roads

For road networks, the government of Sri Lanka focuses on the development of expressways connecting core cities as well as elevation of roads in urban areas with heavy traffic, improvement of unpaved roads, etc. For the improvement of expressways, the following 5 sections are said to have the largest impact on the economy;

- Southern Expressway with Hambantota extension
- Outer Circular Expressway
- Colombo – Katunayake Expressway
- Central Expressway
- Ruwanpura Expressway



Figure 3-7 Network of Expressway

Source: PIP

Among those listed above, the Southern Expressway from Colombo to Hambantota and the Central Expressway connecting Colombo and Trincomalee, attract interest from the government and private companies. This is to avoid overconcentration in Colombo and promote more balanced development of the national land⁶⁰. It is expected that development of these expressways will promote industrial agglomerations in industrial parks in regional core cities including Hambantota and Trincomalee.

Concerning a road network, the need to improve connectivity with railways, etc. as well as its expansion was pointed out in Sri Lanka.

(2) Railways

The Department of Railways runs railway businesses in Sri Lanka. The railways are not electrified and diesel locomotives are used.

Table 3-30 Capacity of Sri Lanka Railways

| | |
|---------------------------|---------|
| Length of railway network | 1,320km |
| Passenger coaches | 500 |
| Goods Wagons | 683 |
| Stations | 343 |

Source: PIP

With increasing traffic, manufacturers and farmers have high expectations for the improvement of freight railways so that environmental loads will be reduced and timeliness will be ensured. If the rail infrastructure is improved and containerized railway transportation becomes more active, the industrial structure in inland areas and such may change. In other words, it is expected that not only agricultural production will increase through agricultural processing as product could be stored fresh but also businesses in the manufacturing sector will expand as they utilize supply chains with the areas along the expressways.

Existing railways in Sri Lanka are old and their coverage is small. PIP points out that the Department of Railways is negative toward reforms although there is large room for improvement in its management. Concerning improvement of railway management, local private companies expressed the opinion that improvement of warehouses and operation of commercial facilities could increase profitability.

⁶⁰ In the field interviews conducted in April 2017, an officer of BOI in charge of EPZ said “Once the Central Expressway is completed, the improvement of the supply chain and the increase in labour migration will be expected since the transit time of two cities will be around three hours”. In the interview with the BOI personnel in charge of EPZ conducted in April 2017, it was pointed out, “After completion of the Central Expressway, the travel time between Colombo and Trincomalee will be three hours, which will improve product supply chains between the two cities and promote labour mobility.”

(3) Ports

The port sector in Sri Lanka, located in the middle of the Indian Ocean, has a large proportion of transshipment demand and it is an important infrastructure sector for the country where acquisition of foreign currencies is a major challenge.

Especially Colombo Port is one of the major ports in Asia, with 5.19 million TEUs in 2015 (28th in the world) ⁶¹. In addition to Colombo, five other ports of Hambantota, Galle, Trincomalee, Oluvil and Kankasanthral are also large.

Table 3-31 Performances of ports sector in Sri Lanka

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------------------------------|--------|--------|--------|--------|--------|--------|
| Total Container (1,000 TEUs) | 4,137 | 4,253 | 4,187 | 4,306 | 4,908 | 5,185 |
| Trans-shipment Container (1,000 TEUs) | 3,205 | 3,216 | 3,167 | 3,274 | 3,781 | 3,967 |
| Total Cargo Handled (1,000 MT) | 61,240 | 65,069 | 65,070 | 66,289 | 74,431 | 77,611 |
| Ship Arrivals (number) | 4,067 | 4,332 | 4,178 | 3,967 | 4,298 | 4,760 |

Source: PIP

AS a hub port in South Asia, the volume of cargo handled at Colombo port is increasing year by year. The government of Sri Lanka is implementing the expansion work of the expansion of the port, aiming at completion in 2020.

(4) Air ports

Bandaranaike International Airport (BIA), Sri Lanka's largest international airport, is located in Katunayake, in the northern part of Colombo, about 30 minutes from Colombo city by car. Approximately 8.5 million people have used the facility in 2015, handling about 208 thousand tons of cargo. BIA is currently implementing passenger terminals expansion work with the support from JICA. The new terminal is scheduled to be connected directly to the expressway between Colombo and Katunayake. Apart from BIA, Mattala Rajapaksa International Airport (MRIA) is in operation since 2013 and is located near the port of Hambantota in southern Sri Lanka.

⁶¹ World Shipping Council (<http://www.worldshipping.org/about-the-industry/global-trade/top-50-world-container-ports>)

3.6.2 Electricity

In Sri Lanka, power generation capacity was 3,392MW and total power generation was 12,357GW in 2014. Peak power demand was 2,284MW in the same year. Electrification rate almost reached 100% during the period.

Table 3-32 Electricity Generation by Source (%)

| | Hydro | Oil | Coal | Renewable Energy | LNG |
|-------------|-------|-----|------|------------------|-----|
| 2015 | 36 | 29 | 23 | 12 | - |
| 2020 (Plan) | 24 | 11 | 30 | 20 | 15 |

Source: PIP

CEB (Ceylon Electricity Board), a state owned company, supplies electric power in Sri Lanka. The government of Sri Lanka understands that improvement of electric power infrastructure is important to attract direct foreign investment and develop industries with EPZs, etc. According to PIP, the government believes that power capacity should increase by 150-200MW each year to meet the growing demand for electric power.

In the meantime, many Japanese companies cite high electricity rates as priority issues to be solved for the electricity sector⁶². Concerning increase of power supply capacity, stable and low-cost power supply should be increased as the weight of renewable energy is increasing.

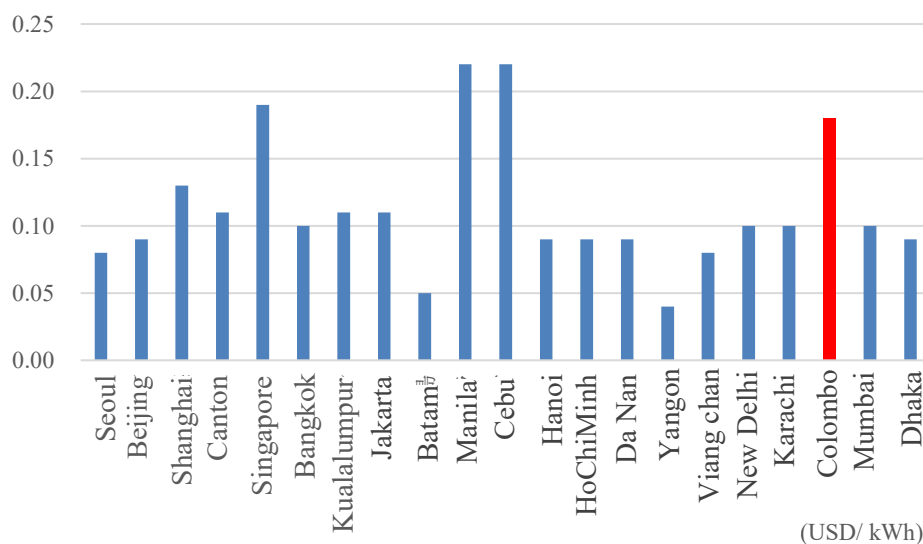


Figure 3-8 Electricity rate of major cities in Asia

Source: JETRO Sensor, 2017

⁶² Created by the Study Team based on “Japan-Sri Lanka Business Needs Survey” (2013, JETRO)

3.6.3 Communication

In Sri Lanka, the broadband diffusion rate, the mobile phone diffusion rate and the land-line diffusion rate are 2.6%, 103.2% and 12.5% respectively as of 2014⁶³. According to the Information Communication Technology (ICT) development evaluation by the International Telecommunication Union, the Asia-Pacific region was ranked as the 20th among 34 regions in 2016 and the broadband communication rate in Sri Lanka was 2-10 Mbit/s, at the same level as the Maldives (12th), Vietnam (16th) and the Philippines (17th). The broadband price is said to be USD 4.1, less than 2% of GNI per capita, and is considered reasonable for the income.

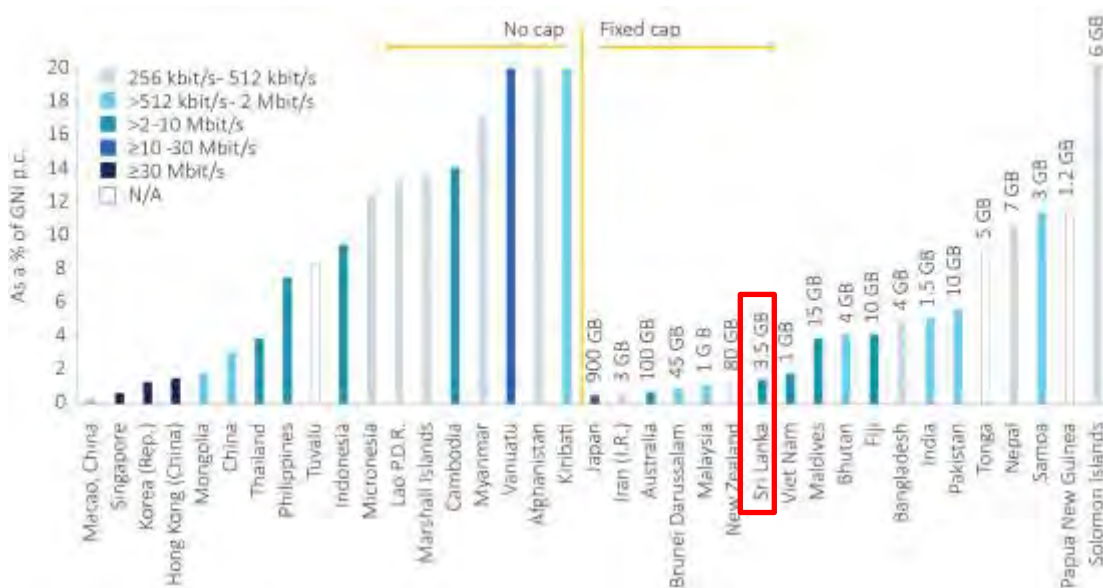


Figure 3-9 Fixed-broadband prices as a percentage of GNI p.c., speeds and caps, Asia and the Pacific, 2015

Source: ITU, Measuring the Information Society Report 2016

According to PIP, the ICT industry is the 5th largest foreign currency earner, and the industry chambers have plans to push the ICT industry to the top contributor to Sri Lankan economy by 2020. It says development of infrastructure and related services is necessary to achieve the goal. SLT, the largest broadband service provider who has about 90% share in the broadband market, acquired a license as a next-generation optical fibre network provider from the Telecom Regulatory Commission in 2013. SLT got a contract for a plan to cover all 329 divisional secretariats within 5 years with the ‘National Backbone Network (NBN)’ and started using DWDM (Dense Wavelength Division Multiplexing) technologies in 2014

⁶³ ITU World Telecommunication/ICT Indicators Database, 2015

3.7 Current State of EPZs (Export Processing Zones)

In this section, we summarized and analysed the development trends and management conditions of the EPZs and industrial parks in Sri Lanka.

3.7.1 Trends of Industrial Park Development

(1) Positioning of EPZs and industrial parks in the policies of the government of Sri Lanka

Since Sri Lanka has historically had many export processing companies, export-oriented manufacturing activities have been encouraged and development through establishment of EPZs and industrial parks (IPs) mainly run by BOI as well as provision of various incentives.

EPZs are for BOI companies specialized in manufacturing of export products. Although IPs are mostly for export-oriented companies, unlike EPZs, not only BOI companies but non-BOI companies are also covered. However, both BOI and non-BOI companies can receive almost the same services (including incentives) despite the difference in their status.

(2) Development progress status

The development status of the EPZs, IPs, developed by BOI is as shown below. A total of 12 EPZs/IPs are currently operating. According to BOI, in addition to the existing facilities, construction of new EPZs and IPs is planned, and they have a policy to actively promote IPs developed by the private sector as well⁶⁴.

Currently, there are two private IPs in Sri Lanka. One is the MAS Fabric Park for apparel companies and the other is the Orion City for IT/business process management (BPM) industries. According to BOI, these existing IPs are specialize in certain industries, but IPs developed by the private sector do not have to be industry-specific. We also hear that there is expectation for development by foreign companies including Japanese developers⁶⁵.

The Government of Sri Lanka mentioned the following two plans in a budget speech on November 2016.

- (A) Establish 4 Free Trade Zones (FTZ) in Kalutara, Rathnapura, Puttlam, and Vavuniya districts.
- (B) Establish 15 Export Villages on a PPP basis.

According to the BOI, the FTZ would be somewhat similar to the existing EPZ. Now they are in the planning stage and will select specific areas for the new FTZ, and require about two years for completion⁶⁶. On the other hand, export village is a new idea and is planned for specific export item. For example, export villages specialized in spice will deal with whole process of cultivation, processing, packaging and exporting in one village. Although there are already some villages specialized in specific products in Sri Lanka, the problem is that no suitable export procedure and centre is available for them.

⁶⁴ From interview with BOI (EPZ personnel) (April 2017)

⁶⁵ Same as above

⁶⁶ From interview with BOI (EPZ personnel) (June 2017)

In addition, establishment of 45 mega zones is mentioned in PIP, and these mega zones are expected to be specialized in a specific product. Therefore, mega zone is basically same meaning with the above-mentioned export village, and it is different from existing industrial parks or EPZs⁶⁷.

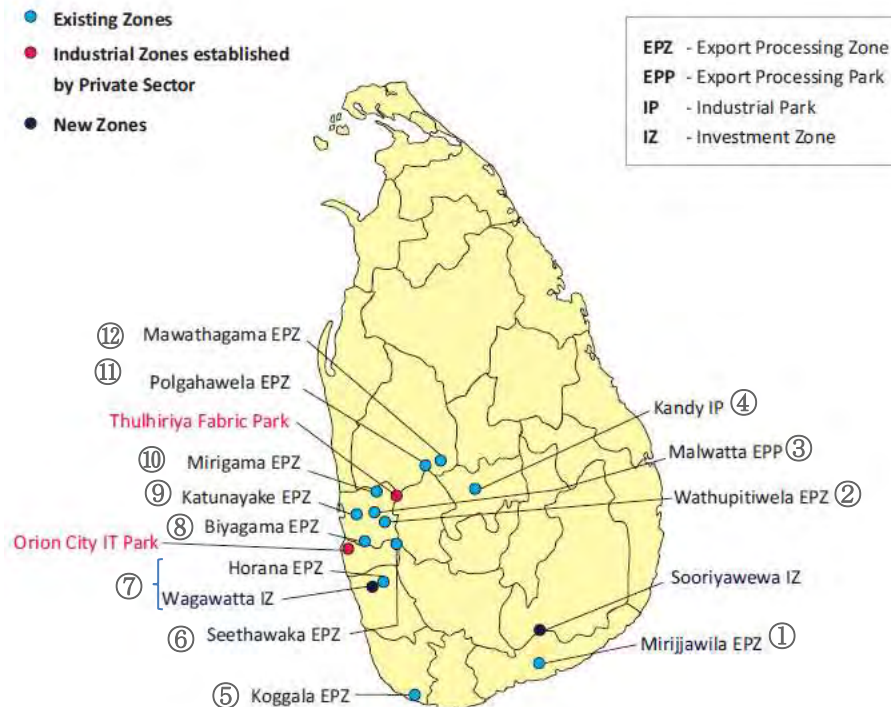


Figure 3-10 BOI Investment Zones⁶⁸

Source: BOI “Investment Guide”

3.7.2 Operation status of EPZs and IPs

The operation status of EPZs and IPs operated by BOI is summarized below.

(1) Incentives and tax benefit for EPZs and IPs in Sri Lanka

Companies located in EPZs o by BOI are BOI companies (approved under the BOI Act Article 16 or 17). In an exceptional case, Kandy Industrial Park has non-BOI companies. BOI companies can receive incentives under the BOI Act Article 16 or 17 whether located in or outside IP.

Companies located in IPs run by BOI are exempted from annual fees as well as to receiving incentives under the BOI Act Article 16 or 17.

(2) State of company agglomerations, vacancies and future planning

The following table shows the state of company agglomerations in IPs and EPZs run by BOI in Sri Lanka. As of October 2016, a total of 281 companies operate in EPZs and IPs in a total of 12 locations. Vacancy is only 105.97 acres (428,845 m²) out of the total area of 1,789 acres (7,239,832 m²). About 94% of the total area has already been occupied, leaving little vacancy.

⁶⁷ Same as above.

⁶⁸ Numbers in the figure correspond to the items in Table 3-33.

Table 3-33 General Details about zones

| | EPZ/IP | Industrial Area (m ²) | Available Vacant Land (m ²) | Occupancy rate (%) | No. of Industries in Commercial operations | Employment (As of 1 st October 2016) | Lease Premium (USD/m ²) | Ground Rent (USD/m ²) | Distance from Colombo (KM) |
|----|---------------------------|-----------------------------------|---|--------------------|--|---|-------------------------------------|-----------------------------------|----------------------------|
| 1 | Katunayake EPZ | 1,238,076 | 37,547 | 97 | 83 | 36,942 | 14.8 | 1.2 | 27km |
| 2 | Biyagama EPZ | 1,036,545 | FULL | 100 | 57 | 26,717 | 14.8 | 1.2 | 24km |
| 3 | Koggala EPZ | 788,970 | 9,387 | 99 | 22 | 12,701 | 7.4 | 1.2 | 132km |
| 4 | Kandy Industrial Park | 329,749 | 48,552 | 85 | 24 | 7,811 | 2.5 | 1.0 | 133km |
| 5 | Seethawaka EPZ | 741,632 | 34,229 | 95 | 26 | 21,670 | 14.8 | 1.0 | 47km |
| 6 | Mirigama EPZ | 693,849 | FULL | 100 | 9 | 3,603 | 7.4 | 1.0 | 65km |
| | Mirigama Block B | 240,899 | 177,741 (Undeveloped) | 26 | - | - | 7.4 | 1.0 | 65km |
| 7 | Malwatta EPP | 106,855 | FULL | 100 | 6 | 1,774 | 7.4 | 1.0 | 38km |
| 8 | Wathupitiwala | 268,573 | FULL | 100 | 18 | 9,500 | 12.4 | 1.0 | 44km |
| 9 | Horana EPZ | 733,135 | 11,329 | 98 | 18 | 2,035 | 7.4 | 1.0 | 50km |
| | Wagawatta Industrial Park | 242,841 | - | - | 6 | 427 | 2.5 | 0.1 | 50km |
| | Wagawatta IZ | 529,217 | 39,246 | 93 | - | - | 9.9 | 1.0 | |
| 10 | Polgahawela EPZ | 160,424 | 30,750 | 81 | 5 | 4,217 | 4.9 | 1.0 | 77km |
| 11 | Mawathagama EPZ | 122,472 | 39,974 | 67 | 7 | 5,543 | 2.5 | 1.0 | 108km |
| 12 | Mirijjawila EPZ | 89,030 | - | - | - | 1,350 | 4.9 | 1.0 | 233km |
| | Total | 7,233,237 | 428,755 | 94 | 281 | 132,940 | | | |

Source: Prepared by the Survey team based on the BOI provided materials (2017) and BOI website

(3) Services provided in IPs

Whether public or private, IPs in Sri Lanka have a BOI office inside providing various administrative services, and each provincial government also provides various administrative services. There are also ample private commercial facilities. Overall, relatively many services are provided on site.

In the case of public EPZs and industrial parks, all services, from development and operation of industrial park to various investor's services such as licenses and approvals, are offered by BOI (specific service contents are listed in Table 3-21). On the other hand, when private sector develops industrial parks, taking MAS Fabric Park, which is the only industrial park in Sri Lanka jointly operated by public and private organizations, as an example, infrastructure development, etc. is conducted by the private sector, and government-related procedures are offered at the BOI office.

As an example, services provided by BOI in Katunayake EPZ are shown below.

Table 3-34 Services Provided by Katunayake EPZ

| |
|--|
| <ol style="list-style-type: none">1. Zone Management Activities<ul style="list-style-type: none">• Access Control Functions• Maintenance of Zones• Solid Waste Management• Procurement of Goods & Services• Transport & Logistical arrangements• Management of BOI properties leased out by other stake-holders• General Administration of BOI properties• General Services to Investors & necessary coordination with Government & Non-government institutions2. Engineering Services<ul style="list-style-type: none">• Provision & Maintenance of infrastructure• Maintenance of BOI buildings and zone• Grant Site Approvals, Building Plan Approvals and Issuance of COC• Recommending Quantities of construction materials for Duty free imports• Maintenance of machinery and equipment such as generators, air conditioners etc.3. Investor Services Department<ul style="list-style-type: none">• Approve export/import Documents• Physical Verification of Cargos• Transfers between BOI, Sri Lanka Customs approved enterprises• Granting sub contract approvals, local sales• Approve machinery, raw materials on loan basis.• Recommend entry/residence and extensions of Visas.4. Industrial Relations<ul style="list-style-type: none">• Monitoring EPF/ETF payments, HR Activities, Statutory payments of enterprises• Advisory services of both employers and employees, Monitor Trade union activities• Brain storming programme for job seekers• Conduct seminars/ awareness programmes for workers• Administration of Day care centre5. Environment Activities<ul style="list-style-type: none">• Provide Guidance to investors regarding environmental matters• Carry out initial environmental assessment |
|--|

| |
|--|
| <ul style="list-style-type: none">• Management of environmental monitoring laboratory• Ensure compliance monitoring of individually industries• Recommendations for issuing/ renewal of EPL• Investigation of complaints regarding environmental matters• Environmental monitoring of industries in and outside KEPZ <p>6. Finance Activities</p> <ul style="list-style-type: none">• Collect revenue• Make payments to BOI staff as well as outside parties• Prepare financial statements• Budgetary control <p>7. Supporting Teams: Zone Management, Security & Fire, Audit</p> <ul style="list-style-type: none">• General Administration of KEPZ & Outside monitoring• Investor Facilitation• Solid Waste Disposal & Management• Round the clock Security• Prevention of Fire hazards & Distinguishing• Auditing and Guiding of internal functions |
|--|

Source: Materials Provided by Katunayake EPZ

258 BOI staff work at the Katunayake EPZ, and provide services listed in the table above. In particular, it is operating as a one-stop service to the tenant companies, when in need of administrative services, licensing, and approvals to government agencies occurring during operation. It also has a framework to absorb and respond to the problems investors are facing, by holding meetings regularly with Manufacturers Association consisting of tenant companies.

On the infrastructure side, as the electricity supply is relatively stable and wastewater treatment facilities are available onsite, both the hard and soft infrastructure are similar to the level of industrial parks in South-east Asia.

However, in Sri Lanka, the various services provided at each EPZ are left to the discretion of each EPZ offices, so not all EPZs offer similar infrastructure or services. Indeed, Katunayake EPZ mentioned that the service provided at Katunayake EPZ is the most substantial among the Sri Lankan public EPZs, and other EPZs have not been fulfilled that much⁶⁹.

(4) Comparison of Sri Lankan industrial parks with other countries

Table 3-35 compares the industrial park and EPZ of Sri Lanka, with representative industrial parks in the ASEAN region where Japanese companies develop and operate.

Although EPZs are considerably small compared with Indonesia on the scale of the industrial park, it is close to the size of industrial park in Vietnam. In addition to the electricity and industrial water supply, some EPZ/IPs are equipped with wastewater treatment facilities.

However, industrial parks in Sri Lanka are almost fully occupied, and it is difficult to extend to the surroundings (i.e. Katunayake EPZ). This contrasts with cases where in the ASEAN industrial parks, they

⁶⁹ Interview to Katunayake EPZ (September 2017).

are gradually expands according to the occupancy condition and accept tenancy in response to additional needs of enterprises.

In terms of soft-service, as described above, various services for investors are provided, and one-stop services by BOI are also provided. Therefore, Sri Lankan SEZs/IPs offer adequate soft-services at the EPZs/IPs.

On the other hand, rental factories widely popular in ASEAN countries including Vietnam and Cambodia, have yet to be introduced in Sri Lanka. Rental factory is a form of operating a factory, by retiling a building which was constructed by developer, and in many cases inside an existing industrial park.

Another option to industrial parks shown in Table 3-25, rental factories are often prepared in the industrial parks where many Japanese companies occupy. A major advantage of rental factory for new entering enterprises is that they can easily move in and start operating in a short term and that they can save initial cost, as building is already constructed. Also, minimum contract period of rental factory is usually as short as about 3 years, whereas around 50 years long lease contract is needed in the case of setting up own factory. Furthermore, minimum size of land for rental factory is usually much smaller than constructing own factories in the industrial park. Thus, rental factories have been very popular among SMEs which don't need large spaces and been rapidly growing in ASEAN from 2010⁷⁰.

In ASEAN there is a history that the needs of rental factories have expanded with the advancement of Japanese SMEs. If Sri Lanka plan to promote the advancement of SMEs, the introduction of rental factories should be considered.

⁷⁰ As an example, in Vietnam, enterprises generally need to purchase land area of 5,000 m² or more when having its own factory, whereas in the case of a rental factory they can purchase lots from around 300 m². It is about 10 times difference in size. According to the "Survey on Industrial Parks in 2013", the size of the land area SMEs require for production is about 500 to 1000 m².

Table 3-35 Industrial Park Comparison between Sri Lanka and Other Countries

| Nation | Vietnam | Vietnam | Indonesia | Indonesia | Sri Lanka | Sri Lanka |
|--|---|--|---|---|---|---------------------------|
| Location | Hung Yen Province | Bing Duong Province | Jakarta | Bekashi | Colombo | Kandy |
| Name of Industrial Park | Tang Long Industrial Park | VSIP II Industrial Park | MM2100 Industrial Park | Karawang Industrial Park | KatunayakeEPZ | Kandy Industrial Park |
| Developer | Sumitomo Corporation | Sumitomo Corporation | Marubeni Corporation | Itochu Corporation | BOI | BOI |
| Area size | 274ha | 320ha | 805ha | 1,389ha | 122ha (306Acres306Acres) | 32ha (81.5Acres5Acres) |
| Availability | Full | Available | Full (1 st – 3 rd phase; 4 th phase under development) | Available | Almost full (3.7ha) | Almost full (4.8ha) |
| Location | 18km to City Area 110km to Port | 32km to City Area 35km to Port | 24km to City Area 35km to Port | 56km to City Area 60km to Port | 27km to City Area | 133km to City Area |
| Number of Enterprises | 101 | 227 | 171 | 136 | 86 | 24 |
| Number of Japanese Enterprises | 93 | 38 | 117 | 114 | 6 | 0 |
| Land Price | NA | 55USD~/m ² | 269USD/m ² | 170USD/m ² | 15USD/m ² (50 year lease) | 2.5USD/m ² |
| Rental Factory Availability | Available | Available | Available | Available | None | None |
| Electricity supply facility (transformation capacity or supply capacity) | 150MVA (50MVAx3) | 6x63MVA | 755MW | Supply capacity inside EPZ (240MW) + supply capacity outside EPZ 60MW | 63MVA | 12MVA |
| Industrial Water Supply | 19,000 m ³ /day 0.267USD/m ³ | 7,900 m ³ /day 0.46USD/m ³ | 72,000 m ³ /day 0.48USD/m ³ | NA | LKR. 75.00/m ³ | |
| Sewage Treatment Capacity | 14,000 m ³ /day 0.276USD/m ³ | 6,000 m ³ /day 0.235USD/m ³ | 72,800 m ³ /day 0.66USD/m ³ | NA | LKR. 17.00/m ³ | None |
| Soft Services | Available | Available | Available | Available | Available | Available |

Source: Prepared by the Survey team based on each Industrial Park/EPZ's website and BOI provided documents

3.7.3 Production outside of the EPZ premises by EPZ companies

Explanation on the bonded area system and development process is written on the BOI website as stated below. These are written on the Custom Ordinance Part XI, Chapter 72, 89, 90, 91, and 95.

(1) Definition of bonded area in Sri Lanka

On the Sri Lankan Customs website, it is stated that there are 7 types of bonded areas in Sri Lanka;

- Private Bonds - Warehouses owned by Private Companies to store goods without payment of duties and taxes under Customs purview
- Public Bonds - Warehouses owned by Sri Lanka Ports Authority to store goods without payment of duties and taxes under Customs purview.
- TIEP I - Facilitates the import of goods for manufacturing, processing or assembling for export on conditional relief from payment of import Duties and Taxes
- TIEP IV - Facilitates the import of Capital and Intermediate Goods used for the manufacture of products and services for export, on whole or partial exemption of Customs Duties and Levies
- IG - Facilitates the import of goods for export purposes which does not qualify under TIEP - I, or TIEP -IV
- Entrepot - Facility to import manufactured or unmanufactured goods from one party of other country on free of Customs duty and other levies for Re-export to a third party of any country as imported or after simple processing (re-packing, re-labelling etc.) with a value addition
- INFAC - Facility provided by the Ministry of Commerce for Non - BOI Apparel Industries to import raw materials and accessories under duty free basis and manufacture and export.

Source: Sri Lanka Custom's website

Following documents are required for application;

Table 3-36 Requirements for Bonding facility

| Area | Bonded warehouse | TIEP I/TIEP IV/IG | INFAC Scheme |
|--------------|---|--|---|
| Requirements | <ul style="list-style-type: none"> • Proposed Project Report • Duly filled application form • BRC & Memorandum of Articles (Form 48) • VAT Registration • Deed/ Lease Agreement (minimum validity period should be two years) • Director's Profile • Company Profile • Audited Financial Statement for the last five years • CCTV Surveillance System • Building & Site Plan (by L-Authority) • Insurance Policy (for building & Goods) • Electrical Installation Certificate (by E/Engineer) • Line Ministry/ Dept. Approval (if necessary) • Boundary Wall, Wire mesh, ceiling with one door • 24 hour security • Easy Accessibility for heavy vehicles | <ul style="list-style-type: none"> • Request letter • Duly filled application forms in triplicate • Project Report • Ministry of Commerce approval for conversion ratios and wastage • Certificate of TIN/VAT Registration • EDB registration certificate • Performa Invoice (TIEP-IV/IG) • Business Registration • Memorandum of Article • NIC/ Passport copies of Directors • Deed or Lease Agreement for warehouse • Other necessary approvals e.g. Tea Board, Coconut Development Authority etc. | <ul style="list-style-type: none"> • Request Letter • Dully filled Application forms in triplicate • Power of attorney signed by a Lawyer • Corporate or Bank Guarantee • Ministry Approval (INFAC only) • TIEP approval (TIEP 1,4 and IBG) • Project Report • TIN/ VAT registration certificate • EDB registration certificate • NIC/ Passport copies of Directors |

Source: Customs website⁷¹

⁷¹ Bonded Operations, http://www.customs.gov.lk/bondedoperation/home#t_3

Restriction and prohibitions are as follows;

- Goods not permitted for bonding are duty paid goods, perishable goods, inflammable/ dangerous goods, prohibited goods, restricted goods without necessary license or permit.
- Permitted period for bonded cargo
 - Two months for confectionary
 - Three months for cigarette and tin foods
 - Six months for wine, beer in bottles
 - Two years for all other goods

Under the regulation initial period will be six months and approval to be obtained for the extension of the period.

Source: Customs website

To legalize consignment production, deed or leasing of private land is given as an example to establish a production base outside of EPZ, or a list of government owned land areas available is provided.

3.8 Current State of Major Export Industries

To identify promising industries in Sri Lanka, in this chapter we first discuss the overview of the recent export trends in the existing major export industries of the country. After that, in next chapter we consider industries with future potential in addition to the existing major industries discussed in this section.

3.8.1 Apparel industry

The apparel industry in Sri Lanka has long established its position as the top export industry, having 41% share in the total export value of the country. With the export value of USD 4,675 million as of 2016, the apparel industry provides direct employment to about 300,000 people (600,000 including indirect employment).

The strength of the apparel industry in Sri Lanka is the ability to provide high-quality and high value-added high-end products from design to manufacturing. It is also characterized by having an advantage in small volume production and being able to accommodate small scale production of various products due to comparatively small working population to other South Asian countries.

Major export destinations are USA and UK, accounting for over 90% of all exports. In the interview with JAAFSL, they said that the apparel industry of the country is motivated for diversification of the export destinations and is trying to change the current situation where they depend on USA and UK for nearly 90% of all exports. As for the concrete destinations, they said that Japan has not really been explored as an export destination but is considered as an excellent market and one of the markets they would like to develop in the future⁷².

⁷² Joint Apparel Association Forum (April 2017)

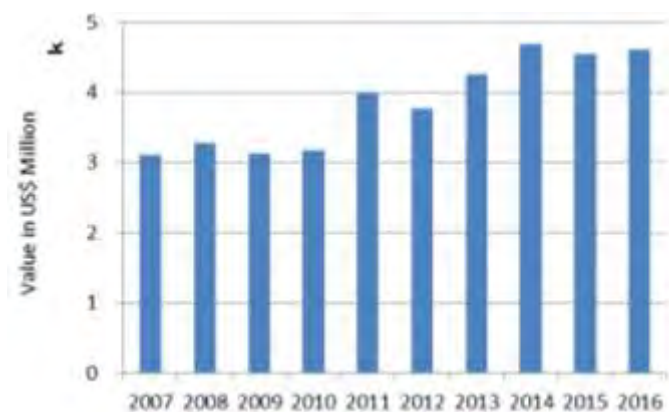


Figure 3-11 Apparel Sector Export Performance (2007–2016)



Figure 3-12 Apparel Sector Major Markets (2016)

Source: EDB website

3.8.2 Food processing industry

In addition to tea, which is a representative export item from Sri Lanka, other major export food items are spice and coconut. Looking at the export values in 2016, USD 1,252 million for tea, USD 311 million for spice and USD 547 million for coconut, tea is the largest export item. Export of the entire food processing field including all these three areas accounts for about 20% of all exports from Sri Lanka.

Different items are exported to different countries. For tea, Middle East and Russia are by far the largest destinations and small portions are exported to Japan and China. For spice, India is the largest market and large amounts are also exported to North America and Latin America. Coconuts are mostly exported to USA and Europe such as Germany and UK.

Although there are multiple representative export items as described above, tea export value has recently hit the ceiling and it seems necessary to increase exports of spice, coconut and other foods. To acquire more foreign currency through exports in these areas, adding of value is believed to be effective. For example, the Sri Lanka Food Processing Association (SLFPA) considers adding of value⁷³ and promotion of branding based on Ayurveda, which has traditionally been carried on, is effective for future industrial development⁷⁴.

Moreover, quality improvement can be a key to further export promotion in the future. During the interview with SLFPA, they said that they see it as a problem that opportunities for export to some markets are missed due to the quality⁷⁵, showing the determination of the entire industry for quality control.

On the other hand, securing human resources is also a serious challenge in further development of the food processing industry. During the interview with SLFPA, they said that it is difficult to recruit highly motivated personnel due to unpopularity of agriculture at the college level and they are also struggling to hire workers because of the competition in hiring workers with the apparel industry and the wage lower than that of the apparel industry⁷⁶.

As described above, the level of the entire food processing industry should be raised through quality improvement, securing labour, etc. Expansion of export, especially of the items other than tea, is expected while export destinations are developed.

⁷³ Specifically, a combination with healthcare industry and necessary labour development, combination with tourism industry were mentioned.

⁷⁴ Interview to SLFPA (April, 2017).

⁷⁵ Same as above Interview to SLFPA (April, 2017). Specific examples include spices. Details were described in 4.2.2.

⁷⁶ Interview to SLFPA (April, 2017)

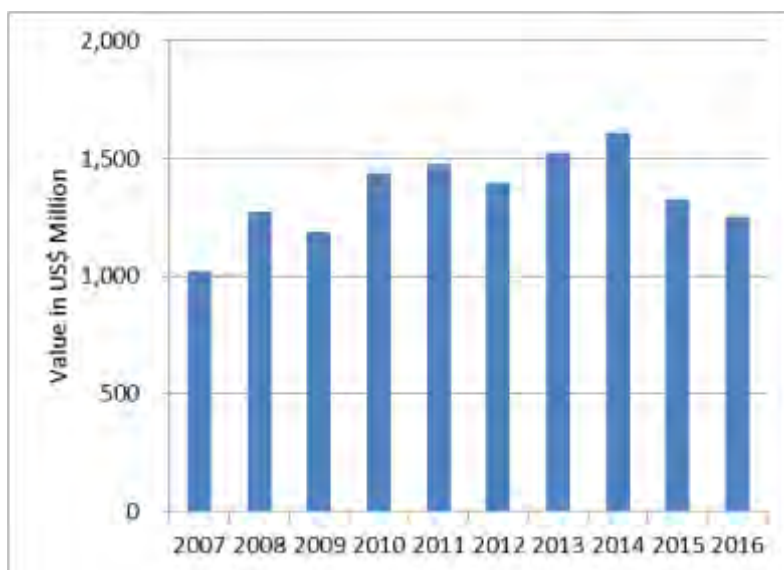


Figure 3-13 Tea Sector Export Performance (2007–2016)

Source: EDB website

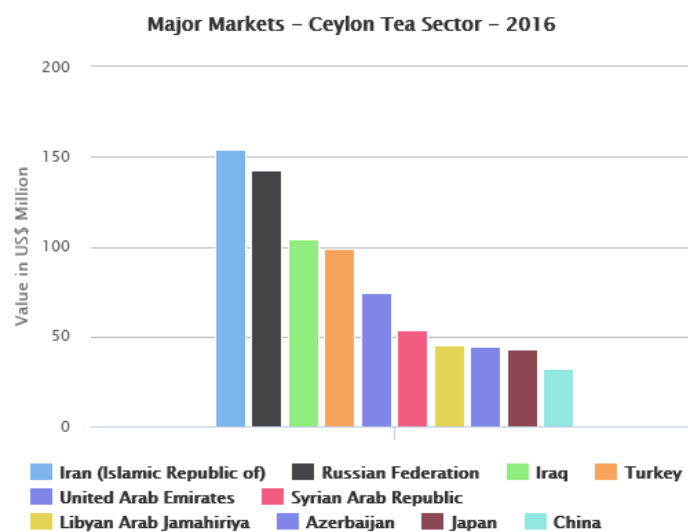


Figure 3-14 Tea Sector Major Markets (2016)

Source: EDB website

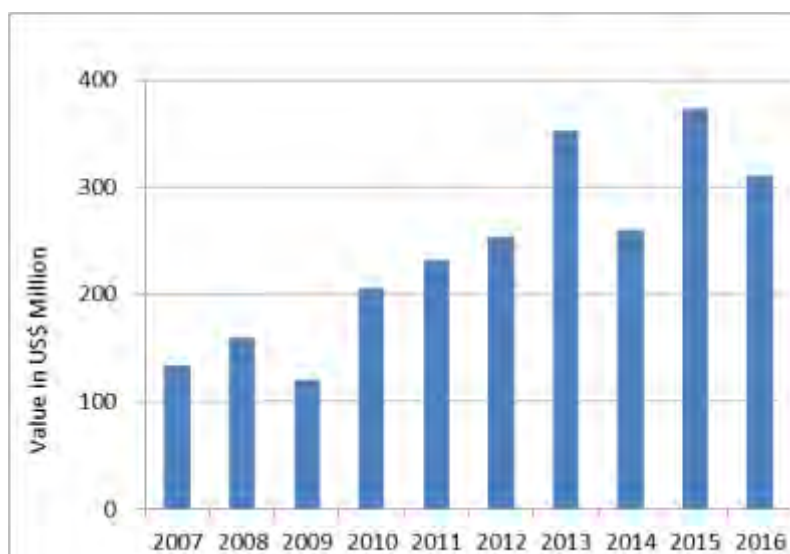


Figure 3-15 Spice Sector Export Performance (2007 – 2016)

Source: EDB website

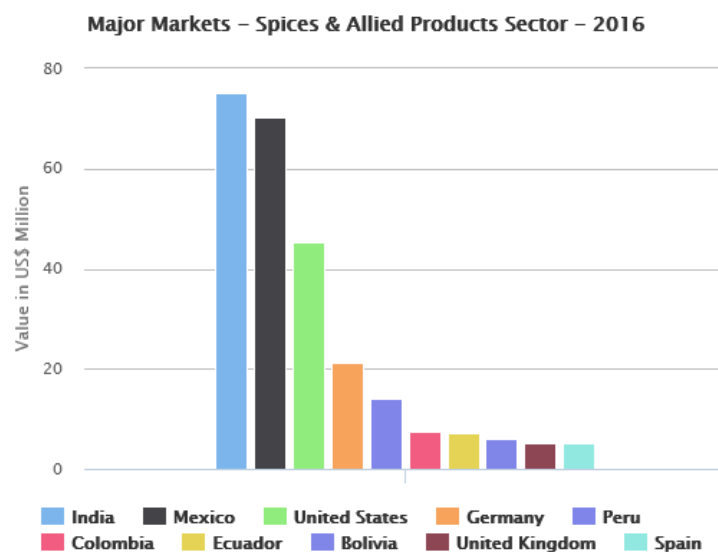


Figure 3-16 Spice Sector Major Markets (2016)

Source: EDB website

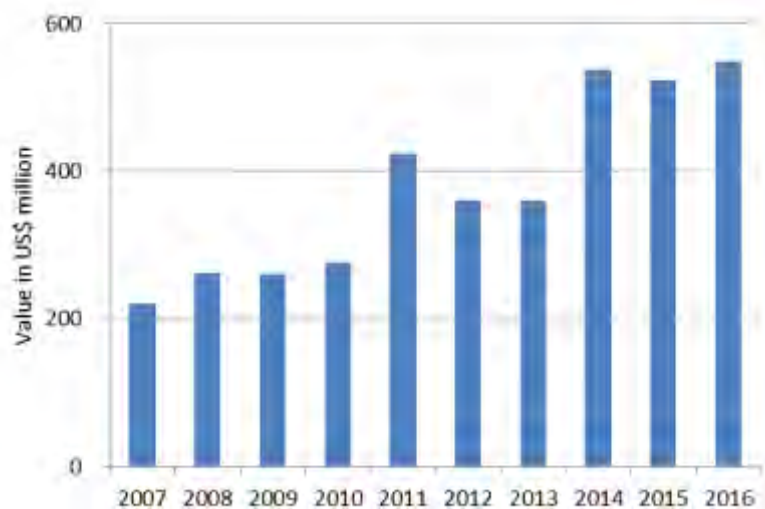


Figure 3-17 Coconut Sector Export Performance (2007 – 2016)
 Source: EDB website

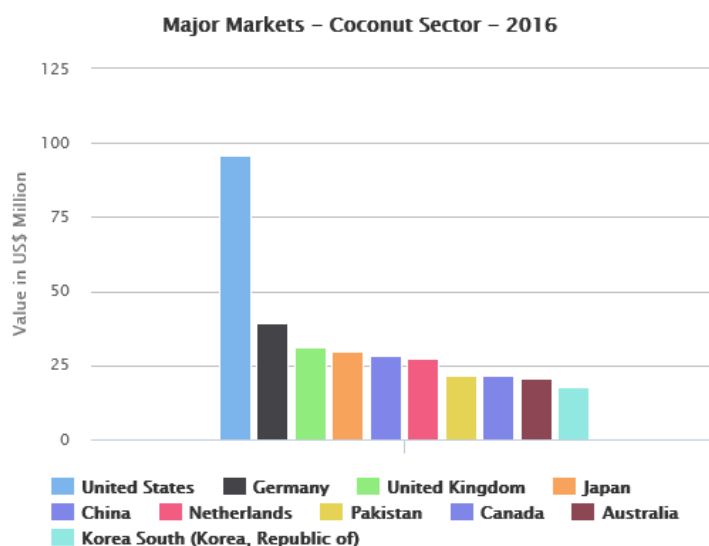


Figure 3-18 Coconut Sector Major Markets (2016)
 Source: EDB website

3.8.3 Rubber industry

Producing 153,000 tons of natural rubber every year, Sri Lanka is the 7th largest natural rubber exporter in the world. The export value of natural rubber and rubber products from Sri Lanka was about USD 8 billion in 2016. Sri Lanka is the largest exporter of solid tires in the world, having a market share of 20%. Major rubber export destinations are USA and Europe, but the top destinations for semi-processed rubber are Pakistan, Malaysia, India, Japan and Germany.

The rubber industry employs over 300,000 people including natural rubber farmers.

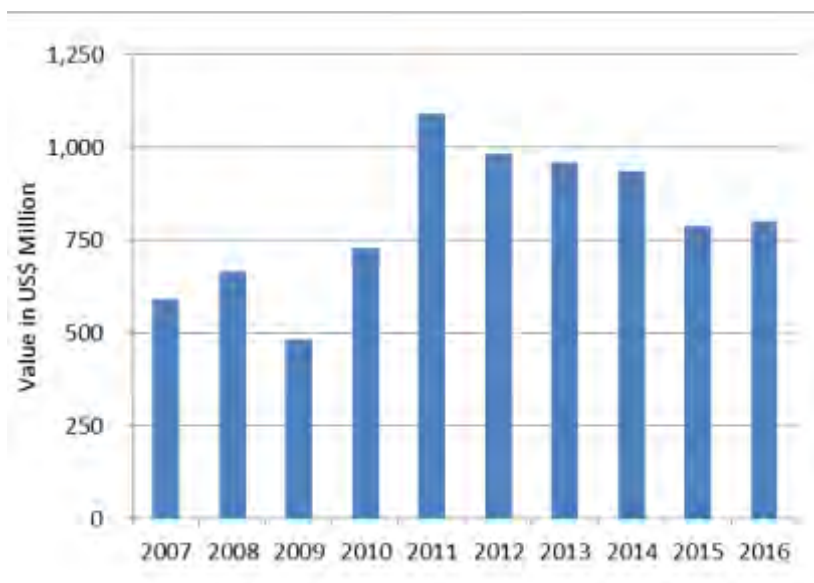


Figure 3-19 Rubber Sector Export Performance (2007–2016)

Source: EDB website

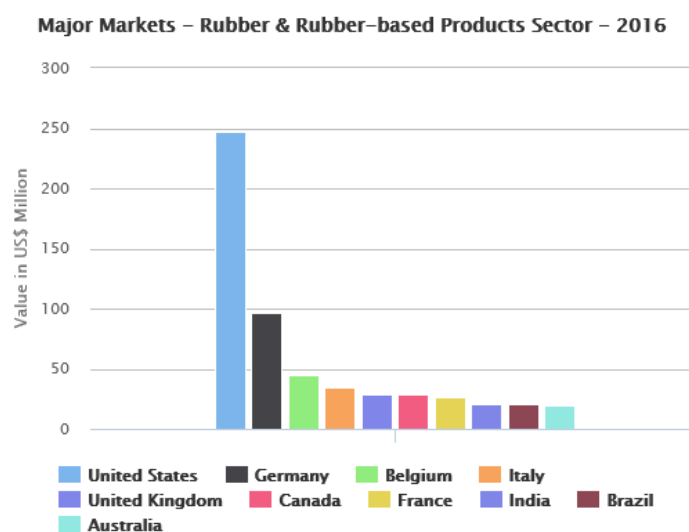


Figure 3-20 Rubber Sector Major Market (2016)

Source: EDB website

3.8.4 Electric and electronics industry

The electric and electronics industry accounts for 3% of all exports from Sri Lanka. The export value in 2016 was about USD 300 million. The industry focuses on small volume production because large volume production is difficult and manufactures some parts and subassemblies for supply chains.

The major markets are Switzerland, USA, India, Germany, etc. As parts in the electric and electronics sector are lightweight and supply chains that mostly use air transportation have been globalized, they can relatively easily enter a market as part of a supply chain without any concern for geographical conditions. Therefore, future development as part of a global supply chain is expected.

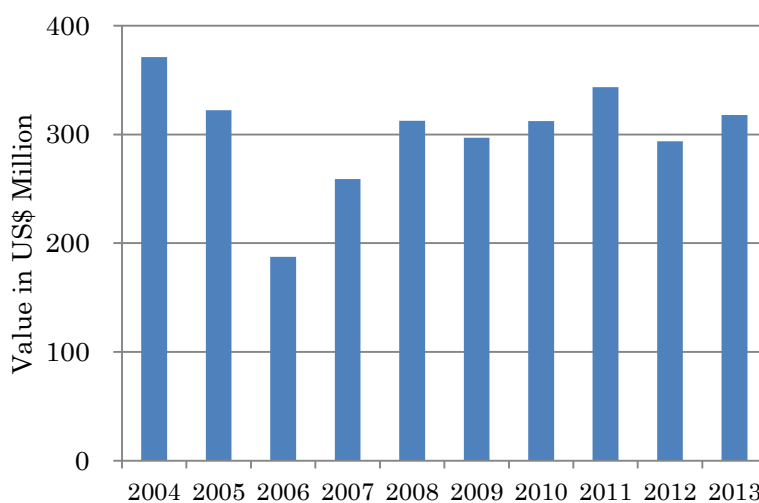


Figure 3-21 Electrical & Electronics Sector Export Performance (2005 – 2015)

Source: EDB website

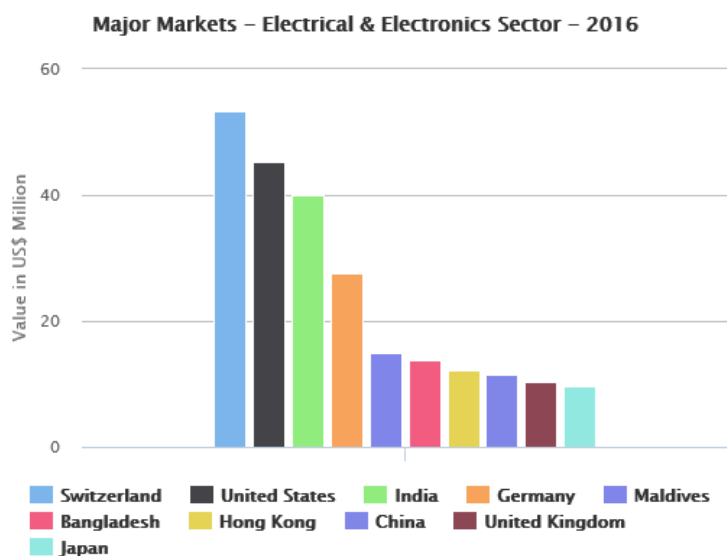


Figure 3-22 Electrical & Electronics Sector Major Markets (2016)

Source: EDB website

3.8.5 Information and Communication Technology (ICT) industry

Having grown by 20 – 30+% every year since 2007 and achieved a growth rate of 238% from 2007 to 2013, the ICT sector has recently shown remarkable growth. The export value reached USD 800 million in 2015 which accounts for 7% of Sri Lanka's total exports, and about 60,000 jobs were created. The industry is expected to achieve a billion-dollar export value and create 100,000 jobs⁷⁷.

The Sri Lanka Association of Software and Service Companies (SLASSCOM) says that the ICT industry in Sri Lanka is characterized by its strength in high-level niche areas. Specifically, it is said to have superiority in BPM (knowledge centre), for which higher abilities are required than so-called BPO (call centre). Therefore, the ICT industry of Sri Lanka peacefully coexists with that of the Philippines, which operates low-end call centres. SLASSCOM mentioned that Sri Lanka is not good for large-scale software development projects of thousands of people because of its small population, but is good for small projects that require high-level technologies⁷⁸.

Sri Lanka competes with India for high-end markets because the major markets of the ICT industry of Sri Lanka are English-speaking countries such as USA, UK and Australia⁷⁹.

SLASSCOM considers that accounting, finance and analytical fields have potential for high-level abilities that will provide the foundation for high-level BPM service provision. They point out that behind it is abundant excellent human resources who have expertise in accounting, finance, etc. in Sri Lanka, where many graduates with A-level⁸⁰ go on to professional schools in these areas. Another reason is that the ICT industry can relatively easily recruit excellent students with A-level who graduated from accounting and other professional schools because it is the most popular industry in the country⁸¹.

However, SLASSCOM is concerned that manpower shortage may grow in case the industry keeps growing at a yearly rate of over 20% and it is said that stable supply of manpower is necessary to maintain such high-rate growth of the industry⁸². In the field of ICT, private companies also provide high-quality schools and education programs in cooperation with overseas programs and the overall level is said to be high⁸³. However, it is also expected that needs in the fields of education will further increase as industries develop.

⁷⁷ Sri Lanka's export performance in 2015 including ICT industry is \$ 11.3 billion.

⁷⁸ Interview to SLASSCOM (April 2017)

⁷⁹ ICT industry in Sri Lanka mainly focuses on high-end markets while ICT industry in India covers low- to high-end markets taking advantage of its large scale.

⁸⁰ General Certificate of Education, Advanced Level

⁸¹ Interview to SLASSCOM (April 2017)

⁸² Same as above

⁸³ Same as above

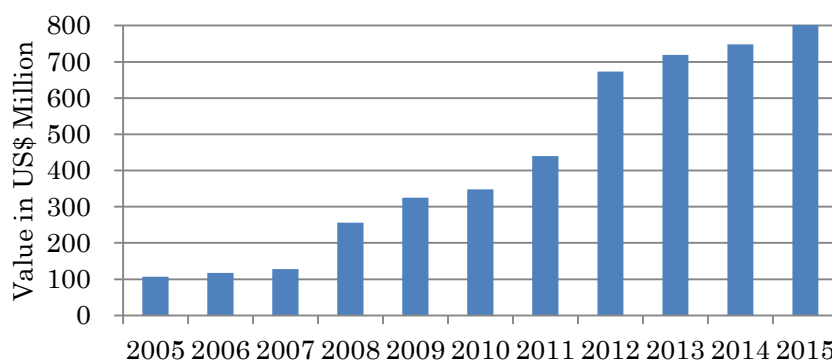


Figure 3-23 ICT/BPO Export Performance (2005—2015)

Source: EDB website

3.8.6 Tourism industry

Sri Lanka is blessed with tourism resources such as eight world heritage sites, natural parks and resort hotels. After the end of the civil war, the number of tourists has dramatically increased, and expectation to the tourism sector as a driving force of the Sri Lankan economy is high. In fact, tourism has become a second largest foreign currency acquisition industry next to the apparel industry.

The number of tourist arrivals were approximately 450,000 in 2009⁸⁴. However, it continues to grow at more than 20% per year and has exceeded 2 million in 2016. It has grown more than 4 times in seven years.

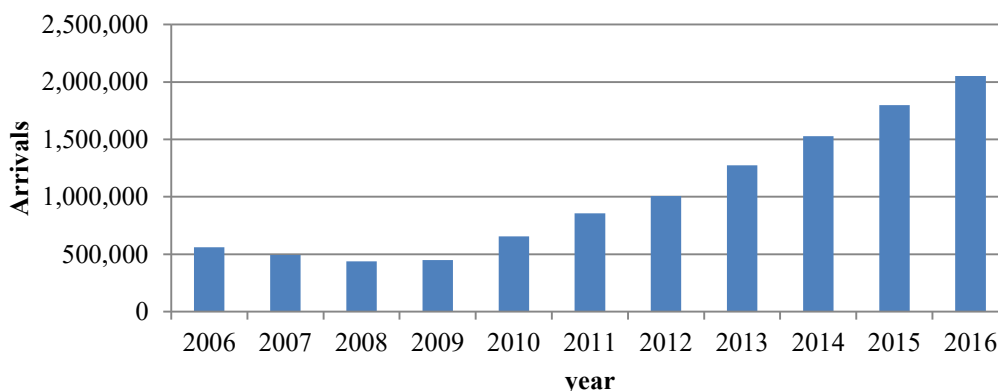


Figure 3-24 Tourist Arrivals (2006~2016)

Source : Annual Statistical Report of Sri Lanka Tourism (2011, 2016)

⁸⁴ According to Sri Lanka Tourism Strategic Plan (2017-2020), 80-90% of tourist arrivals visits Sri Lanka for their holiday.

The figure below shows the trends in the number of tourists by country. As of 2016, India, China, UK sent lots of tourists to Sri Lanka. Especially for China, the number of visitors has been extremely low until 2011, but it has grown rapidly over the past five years. Also, India has doubled the number of tourists in the past five years.

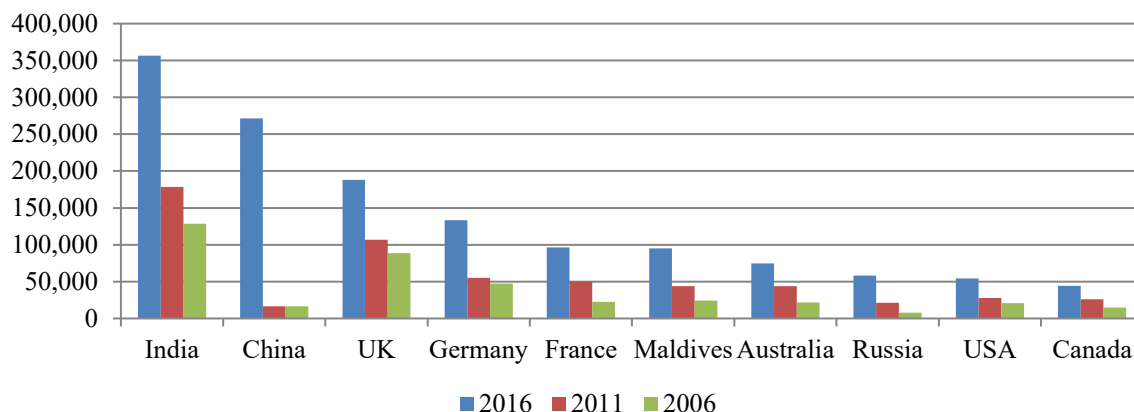


Figure 3-25 Tourist Arrivals by Country (2006, 2011, 2016)

Source : Annual Statistical Report of Sri Lanka Tourism (2011, 2016)

The figure below shows the trends in tourism revenue. It is understood that tourism revenue is also increasing in proportion to the increase in the number of tourists. The contribution from hotel revenue growth, which is the main source of income, is significant. Tourism revenue in 2015 amounts to about 3.5 billion USD.

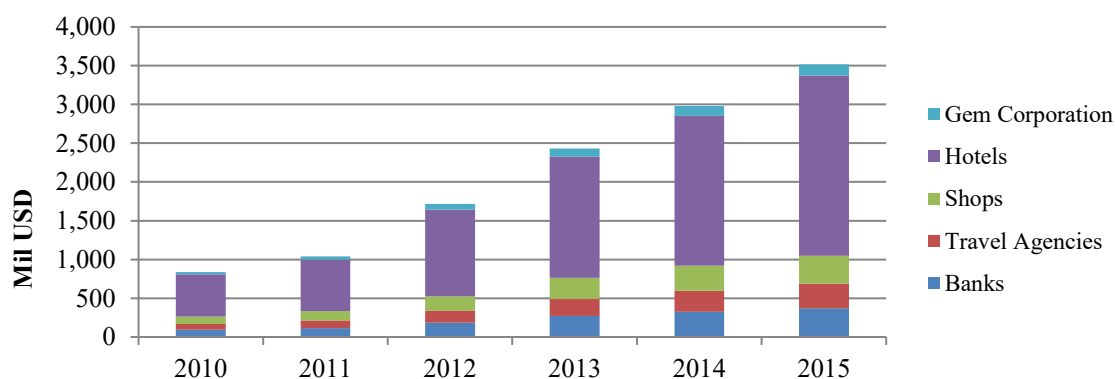


Figure 3-26 Trends in tourism revenue (2010~2016)

Source : Annual Statistical Report of Sri Lanka Tourism (2011, 2016)

According to Sri Lanka Tourism Strategic Plan 2017-2020, Sri Lanka sets the goal to make tourism revenue to USD 7 billion in 2020. To achieve that goal, Sri Lanka aims to not only increase the number of tourists, but also to increase the tourism unit price, and set the goal of increasing the daily expenditure of tourists to USD 210 (USD 164 in 2015).

4 Sri Lanka's Business Environment from Investor's Perspective

In this chapter, the business environment is evaluated with regard to production factors, availability of natural resources, the domestic and regional markets, and the perspectives of foreign direct investment in each sector. Identification of industries in need of foreign direct investment is followed, which takes into account advantages of each industry in Sri Lanka compared to that of other countries. The position of Sri Lankan industries within the global value chain is also assessed, along with issues and reasons for investment.

4.1 Competitive Advantage of Sri Lanka

In analysing investment potential, required condition for investment or investors' point of views are considered. Decisive factors of Sri Lanka's competitive advantages (resource availabilities and/or cost competitiveness) are major subject of assessment. Meanwhile, products made in Sri Lanka and neighbouring markets are assessed of its market share, growth rates, international market trends, and major players' investment behaviours.

4.1.1 Evaluation of Sri Lankan Business Environment

The Sri Lankan business environment exhibits the following characteristics:

- Limited domestic market (population of approximately 20 million)
- Export hub for North America, Latin America, Europe, the Middle East, and Africa; access to both Europe and East Asia; located near India
- Per capita GDP approaching USD 4,000 (approx. USD 3,850)
- High literacy rate
- Supporting industries are undeveloped; difficulty in procuring manufacturing parts domestically (dependent on imports)
- Ranked 110 in "Doing Business" is not at the level of ASEAN countries, though ranked highly compared with neighbouring Southwest Asian countries,

The image of the civil war remains among foreign investors, although 8 years have passed since it ended. Thus, Sri Lanka tends to be under evaluated when political stability is compared with other countries. Also, the population size puts the country at a disadvantage when compared to other investment destinations.

Table 4-1 Development level comparison between Sri Lanka and other countries

| | China | Thailand | Philippines | Vietnam | Indonesia | India | Bangladesh | Sri Lanka |
|--|-----------------------------|---|-----------------------------|------------------------------|-----------------------------|----------------------------|-----------------------------|-----------------------------|
| Population (Million) | 1,373 | 69 | 102 | 92 | 255 | 1293 | 160 | 21 |
| Nominal GDP (Billion USD) | 11,182 | 395 | 292 | 191 | 859 | 2073 | 207 | 81 |
| GDP per capita (USD) | 8,141 | 5,742 | 2,863 | 2,088 | 3,362 | 1,604 | 1,292 | 3,849 |
| Literacy Rate (%) | 96 | 94 | 97 | 98 | 95 | 72 | 61 | 93 |
| Life Expectancy (age) | 75.8 | 74.4 | 68.3 | 75.6 | 68.9 | 68.0 | 71.6 | 74.8 |
| Poverty Rate (%) | 1.9 (2013) | 0.0 (2013) | 13.1 (2012) | 3.1 (2014) | 8.3 (2014) | 21.2 (2011) | 18.5 (2010) | 1.9 (2012) |
| Number of Cars Owned (per 1000 people) | 102 | 232 | 35 | 22 | 83 | 22 | 5 | 50 |
| Rank of Doing Business 2017 | 78 | 46 | 99 | 82 | 91 | 130 | 176 | 110 |
| Corruption Perception Index 2016 | 40 (79 th) | 35 (101 st 101 ^s t) | 35 (101 st) | 33 (113 th) | 37 (90 th) | 40 (79 th) | 26 (145 th) | 36 (95 th) |
| Global Terrorism Index 2016 | 6.11 (23 rd) | 6.71 (15 th) | 7.10 (12 th) | 0.00 (130 th) | 4.43 (38 th) | 7.48 (8 th) | 6.48 (22 nd) | 3.49 (53 rd) |

Source: JETRO (2017)

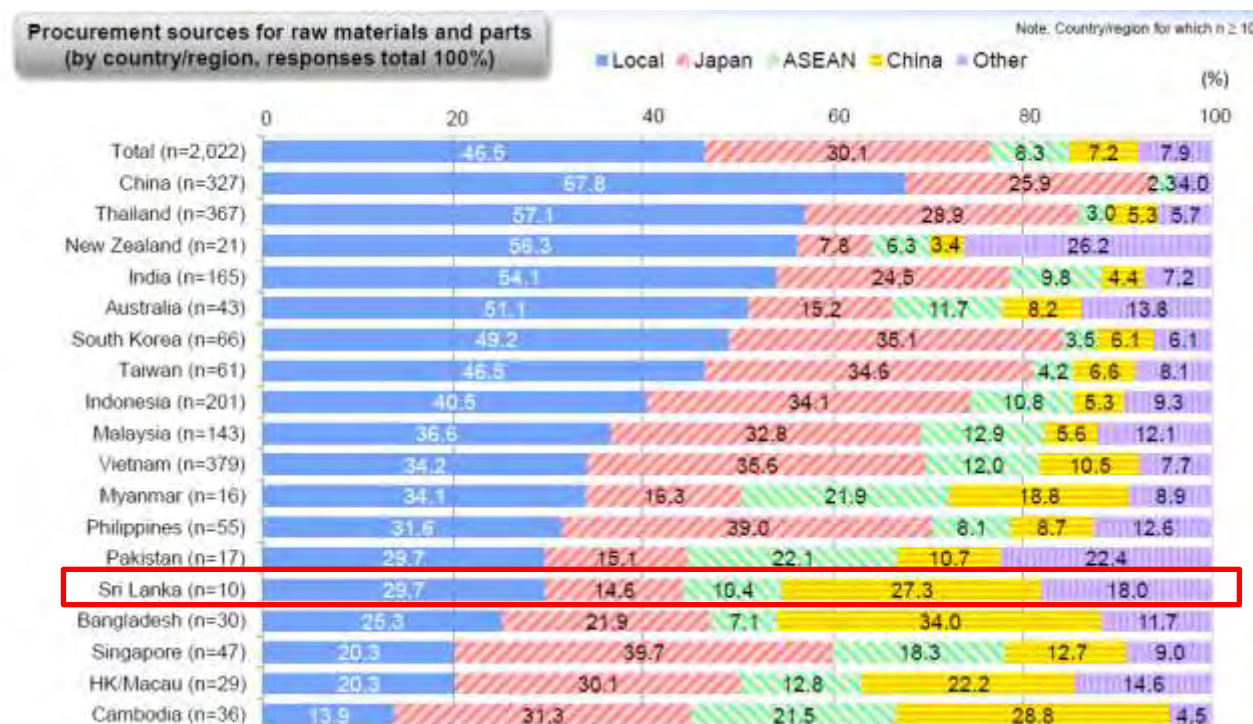


Figure 4-1 Procurement Sources for Raw Materials and Parts

Source: JETRO (2016) "2016 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania"

4.1.2 Labour Force

Based on Japan-Sri Lanka Business Needs Survey conducted by JETRO in 2013, the strengths and weaknesses of Sri Lanka, in terms of labour force are outlined as below.

(1) Strengths of Sri Lankas' labour force

- Highly skilled workers and high productivity (product defective rate is low)
 - Highly skilled factory workers. Several times faster and more accurate than Japanese factory workers, and have good eyesight.
 - Employees are earnest. Twice as productive as Thai employees. Productivity was low at the beginning of the operation with high defective rate, but surpassed that of Thailand in 1 year.
 - Sri Lankans are diligent. Highly productive, with a product defective rate of 200 PPM (0.00025%)
- Highly literate and with good English proficiency
 - Sri Lankans have proficiency in English with good pronunciation. Also, Sinhalese grammar is similar to Japanese, making it easier for Sri Lankan to learn Japanese.
- Turnover Rate is relatively lower than other countries; loyalty to the company is high
 - Average rate of employees leaving their jobs in Sri Lanka is close to 20%. Many Japanese companies operating locally have reduced the rate to 5% with various methods.

Source: JETRO (2013) "Japan-Sri Lanka Business Needs Survey", Survey team local interviews

(2) Weaknesses of Sri Lankan labour force

- Difficulty to secure human resources
 - Difficult to secure human resources to increase productivity, especially middle management class. With hardly any internationally competitive manufacturing industry other than apparel, there are few human resources for manufacturing. On a national level, Sri Lanka is not accustomed to the manufacturing sector.
 - Hiring new people is difficult for factory, because social perspective on factory work regarded as low. Workers constantly need to be supplemented.
 - Engineers in Sri Lanka are required to graduate from university; there is no engineering qualification available for high school graduates. As university education is still a small portion of high school graduates, it results in a lack of engineers. There is also a shortage of management personnel. Many companies hire Indians and Filipinos for managing roles.
 - Applicant responses to newspaper advertisements for job vacancies are declining.
 - Recently, university graduates and other highly qualified personnel tend to prefer communications, IT, hospitality, and other service sector jobs.

- Lack of human resources with manufacturing sector background
 - Lack of manufacturing sector background is an issue. There are few candidates for technical staff, including factory/plant management and equipment/machinery maintenance. Due to scarce qualified workers, companies must train employees internally.

Source: JETRO (2013) Japan-Sri Lanka Business Needs Survey

A comparison of salary levels between Sri Lanka and other countries is given in the following figure. Salary levels are lower for workers, engineers, and managers compared to ASEAN countries and India. Considering their distinguished value, the worker class labour forces in Sri Lanka is cost effective, considering its ability.

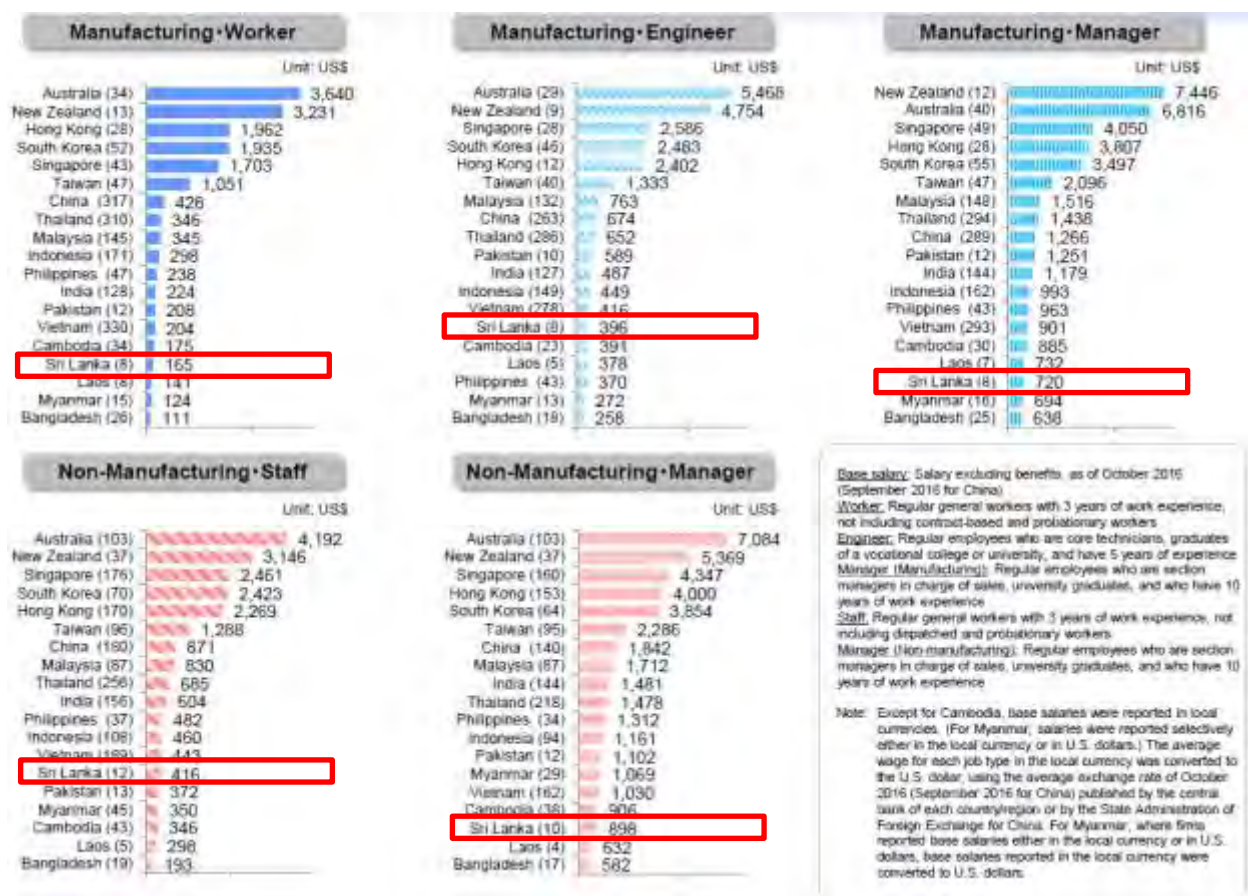


Figure 4-2 Base Salary (monthly)

Source: JETRO (2016) “2016 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania”

(3) Skilled labour capacity development for the industry

Sri Lanka has vocational schools to train labour force for the country. Additionally, with the support from the ADB, the Technical and Vocational Education and Training (TVET) curriculum aims to augment programs at vocational training schools. In addition, more than 200 vocational training facilities are run by the Ministry of Youth Affairs and Skills Development (MYASD).

① German Tech

German Tech, officially the “Ceylon German Technical Training Institute” was established in 1985 with support from the German Baden-Württemberg government. The school aimed to support labour force for the then established Daimler-Benz AG, which was in need of maintenance of their bus operation in Colombo. There were 140 new students annually entering to school in its early years, which has grown to 600 today. Courses include automobile, millwright fitting, tool machinery, power electrical, A/C refrigeration, auto electrical, welding, diesel pump mechanism, auto A/C, and macaronic technology. Duration of courses varies from 3 to 4 depending on subjects, but all first grade students take a basic engineering training on manufacturing tools from metal materials. Result of the final examination of the first grade determines the courses of the second grade and onwards. After the second year, students are divided by course to take customized practical training. Every course includes on the job training in their last year. Today, German Tech is run fully by the Ministry of Skills Development Vocational and Technical Education, so students do not pay tuition.

However, about half the graduates from German Tech go abroad, to countries such as New Zealand, Australia and the Middle Eastern to find a job. This is because it is easier to find a job with better payment outside of Sri Lanka.

② Other TVET (Technical and Vocational Education and Training) programs in Sri Lanka

ADB provides support along with Korea and France to TVET, run by the Ministry of Youth and Skills Development. This program aims to improve training courses for construction, tourism, information technology, and light manufacturing. Specifically, it aims to improve quality of the courses, to cooperate with the private sector in planning the education programme for TVET.

There are other vocational training institutions, including those specifically for information technology, computer skills, and for apparel, built adjacent to factories or working premises. There is also a plan to build a vocational training facility within the Katunayake EPZ run by the BOI, to maintain the supply of skilled labour.

③ Issues with skilled labour capacity development scheme

To maintain a supply of skilled labour forces, following points need to be improved. Below points will be discussed based on interviews with the German Tech, MYASD, and private companies.

a. Less opportunities for work in the country after graduation

As seen in the example of German Tech, even though schools are run by public, a large proportion of graduates go abroad due to lack of work opportunities within Sri Lanka. According to MYASD, it is perceived that although labour forces move abroad, they will be sending money to Sri Lanka, which will increase foreign exchange earnings to the country, therefore graduates finding jobs outside of the country is not a critical issue. However when considering inviting foreign direct investment, sufficient labour force to support operations in Sri Lanka is necessary. It is important to educate students while showing work

opportunities after graduation, and cultivate industrial human resources including career development after graduation.

b. Lack of teachers/ instructors and facility

As it was mentioned at German Tech, the capacity of teachers and facility to conduct sufficient practical training is lacking.

④ Cases of other countries

Human resource development supports by JICA in other countries are listed in Table 4-2.

Table 4-2 Cases of vocational trainings support by JICA in Sri Lanka's competitor countries

| Country | Name of project | Outline | C/P |
|-----------|--|---|---|
| Thailand | Automotive Industry Labour Development Project | In order to supplement skilled labour loss in the automobile sector in Thailand due to production increase, maintenance of certification processes and educational systems were included. | TAI: Thailand Automotive Institute |
| Kenya | Project on Human Resource Development for Industrial Development | Mainly development of management labour for Small Medium Enterprises | KIBT : Kenya Institute of Business Training |
| Vietnam | Project on Human Resource Development for Industrial Development | Sending of students to Japan for practical training, and support for employment to Japanese companies in Vietnam | Human Resource Development School |
| Indonesia | Project on Human Resource Development for Industrial Development | Provision of finance to build a school for training students who plans to go to Japan for practical training. | PT. JIAEC |

Source: JICA websites

⑤ Sri Lanka's direction on human resource development

Chapter 2 of PIP discuss both higher school education and vocational training as human resource development contributing to national growth. PIP affirms the benefits of free-education which successfully build the high-level of general skill capacities in Sri Lanka, but at the same time it is addressing a shortage of skilled labour forces in the industry. Particularly, PIP pays attentions to the "Disparity between the

outcome of university education and the labour market requirement⁸⁵. Table 4-3 shows the employment status of university academic degree holders in Sri Lanka, and the difficulty in supplying sufficient labour opportunities for them.

Table 4-3 Employment rates of degree holders by Discipline in 2013

| Discipline | Employed | Under Employed | Unemployed |
|-------------|----------|----------------|------------|
| Engineering | 94.7 | 1.4 | 3.0 |
| IT | 92.5 | 1.9 | 4.5 |
| Medicine | 91.4 | 2.4 | 4.8 |
| Science | 71.0 | 6.4 | 22.1 |
| Agriculture | 69.7 | 6.7 | 23.6 |
| Management | 66.4 | 14.4 | 18.8 |
| Arts | 32.1 | 20.1 | 46.2 |
| All | 58.8 | 13.2 | 26.9 |

Source : p.22, PIP

The data suggests the shortage of engineering skilled labours, as the PIP calls for “short term technical higher education programs⁸⁶”.

The table 4-4 shows Sri Lanka’s vocational training schools. PIP does not provide clear definition of Sri Lanka’s future industry skilled labour.

Table 4-4 Network and Performance of Existing Vocational Training Centres

| Name of School | No. of locations | No. of students | | |
|---|------------------|-----------------|--------|--------|
| | | 2013 | 2014 | 2015 |
| Ministry of Skills Development and Vocational Training | | | | |
| Department of Technical Education and Training | 30 | 22,736 | 22,863 | 19,864 |
| Colleges of Technology (CoTs) | 9 | -- | -- | -- |
| Vocational Training Authority (VTA) | 240 | 28,446 | 28,692 | 28,745 |
| National Apprentice and Industrial Training Authority (NAITA) | 68 | 23,613 | 21,443 | 22,878 |
| National Institute of Fisheries and National Engineering (NIFINE) | 8 | 2,123 | 2,061 | 1,805 |
| Ceylon German Technical Training Institute (CGTTI) | 2 | 4,516 | 3,285 | 4,175 |
| Sri Lanka Institute of Printing (SLIOP) | 1 | 886 | 864 | 928 |
| National Institute of Business Management (NIBM) | 4 | 10,879 | 9,775 | 9,572 |
| National School of Business Management (NSBM) | 1 | 2,459 | 2,165 | 1,427 |
| University of Vocational Technology (UNIVOTEC) | 1 | 352 | 421 | 545 |

⁸⁵ PIP 2017-2020, p.22.

⁸⁶ PIP 2017-2020, p.22.

| Name of School | No. of locations | No. of students | | |
|--|------------------|-----------------|--------|--------|
| | | 2013 | 2014 | 2015 |
| Ministry of National Policies and Economic Affairs | | | | |
| National Youth Services Councils (NYSC) | 47 | 20,158 | 19,513 | 18,789 |
| National Youth Corps (NYC) | 37 | 9,558 | 10,530 | 8,071 |
| Training Providers in other Ministries | | | | |
| Sri Lanka Institute of Advanced Technological Education (SLIATE) | 18 | 5,172 | 6,696 | 6,942 |
| Agriculture Schools | 9 | 220 | 229 | 300 |
| Vocational Training Centres for Differently Abled Children | 16 | 590 | 609 | 334 |
| Animal Husbandry Schools | 2 | - | 168 | - |
| Gem and Jewellery Research and Training Institute | 6 | 460 | 599 | 674 |
| Institute of Construction Technology | 2 | 60 | 60 | 60 |
| Private training institutions (Training centres registered under Tertiary and Vocational Education Commission) | 611 | 43,693 | 51,055 | N/A |

Source : p.26, PIP

4.1.3 Logistics

(1) Strategic Location with Favourable Access to Multiple Markets

Sri Lanka offers favourable geographical location providing access to multiple markets, which gives an advantage as a production base. The country is located halfway between the Far East and Western markets, neighbours to the massive Indian market, and lies just east of the Middle Eastern and African markets⁸⁷.

Given these geographic advantages, JETRO suggests that Sri Lanka should seek new business in three directions: to the north with India, Pakistan, and Bangladesh; to the east with ASEAN countries, China, and Japan; and to the west with Europe, the Middle East, and Africa.

Reflecting above observation, Japanese companies moving into Sri Lanka also indicate that they are exporting to various markets, including Japan, Europe, North America, and Latin America.⁸⁸

⁸⁷ JETRO (2013) Japan-Sri Lanka business needs report

⁸⁸ Confirmed in interviews with multiple Japanese companies operating locally.



Figure 4-3 Look NEW Market

Source: JETRO (2013) “Japan-Sri Lanka Business Needs Survey (2013)”

For Japanese companies operating in Sri Lanka as an offshore operation of the company, majority of export are destined to Europe and US market. The export opportunities to Middle East and Africa, also make Sri Lanka even more attractive as an export centre.

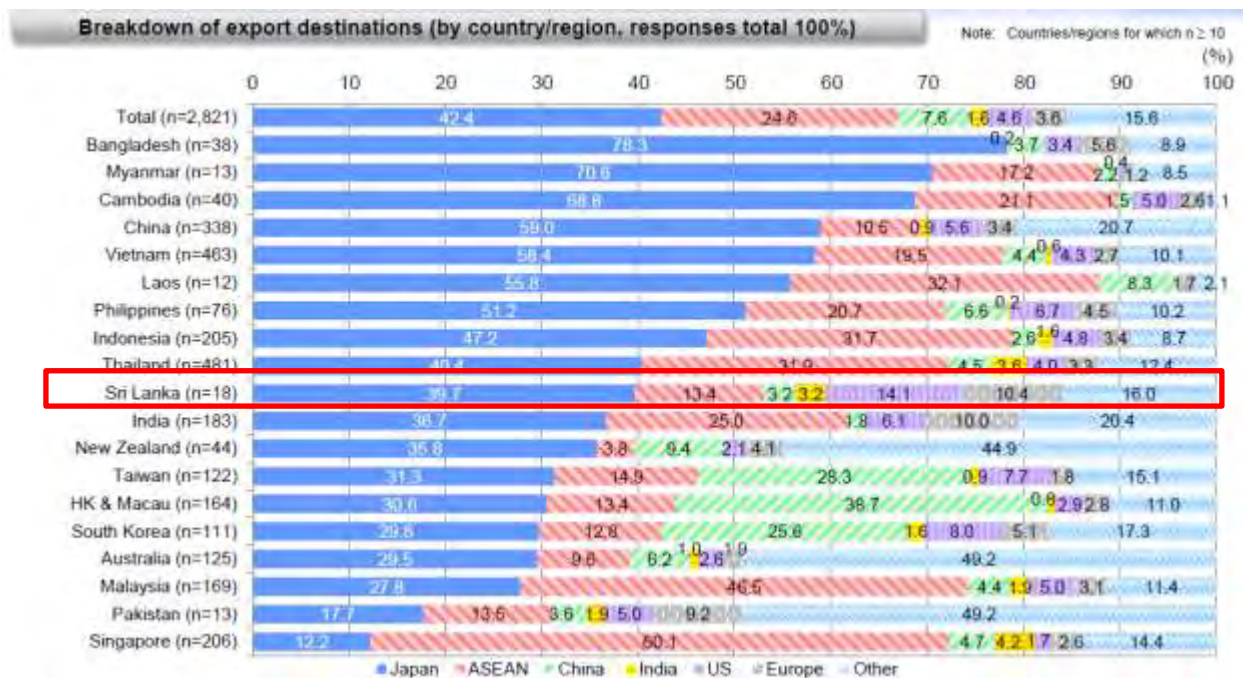


Figure 4-4 Breakdown of Export Destinations (by country/region, responses total 100%)

Source: JETRO (2016) “2016 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania”

(2) Cost Competitiveness

Costs of cargo shipping from Sri Lanka to major export destination are generally low. For example, shipping cost from Singapore to Sri Lanka is USD 1,000 for 20 feet container; it is only USD 100 from Sri Lanka to Singapore. Furthermore, the costs and handling charges associated with ocean freight such as labour, warehousing are relatively cheap in Colombo Port⁸⁹.

Table 4-5 Comparison of Cargo shipping cost

| Section | Colombo Port → Destination | | Departure→Colombo Port | |
|-----------------|----------------------------|-------------------|------------------------|-------------------|
| | 20 feet container | 40 feet container | 20 feet container | 40 feet container |
| Tokyo | 400 | 500 | 1,100 | 1,500 |
| Singapore | 100 | 250 | 1,000 | 1,200 |
| New York (USA) | 2,200 | 3,700 | 1,200 | 1,600 |
| Mombasa (Kenya) | 1,100 | 2,100 | 1,100 | 1,600 |
| Mumbai (India) | 150 | 300 | 350 | 400 |
| Dubai (UAE) | 400 | 800 | 500 | 700 |
| Felixstowe (UK) | 800 | 1,600 | 800 | 1,400 |

*Average fee for general cargo as of March 2015.

Source: JETRO (2015), "Survey Report on the Reality of Sri Lankan BOP sector (Logistics Condition)"

⁸⁹ For example, regarding labor costs, Singapore's hourly wage is USD 13 while Sri Lanka's hourly wage is USD 1.5. Similarly, warehouse costs of Singapore is USD 13.3 per square foot while that of Sri Lanka is USD 4.8. (Source: JETRO (2015), "Survey Report on the Reality of Sri Lankan BOP sector (Logistics Condition)")

4.2 Selection of Sri Lanka's potential industries

This section specifies sectors in Sri Lanka, particularly requires foreign direct investment, with its significance and issues of investment through comparison of Sri Lanka's comparative advantages. The assessment highlights Sri Lanka's position within global value chain and how foreign direct investment can impact the sectoral development.

4.2.1 Potential Sectors

Table 4-6 shows the recent trading trends of potential industries. For agricultural products, tea, coconut and spices are the biggest exports by value. Coconut and spices are growing export at an annual rate of 10%. For industrial products, textiles and garment are the workhorses for export, comprising 60% of all industrial product exports. Rubber and petroleum products are also showing steady growth.

Table 4-6 Value of Exports 2010-2015

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | US\$Mn, % Average Rate of Growth(2010~ 2015) |
|-----------------------------|--------------|---------------|--------------|---------------|---------------|---------------|---|
| Agricultural Export | 2,306 | 2,528 | 2,332 | 2,581 | 2,794 | 2,483 | 1.5 |
| Tea | 1,441 | 1,491 | 1,412 | 1,542 | 1,628 | 1,341 | -1.4 |
| Rubber | 173 | 206 | 125 | 71 | 45 | 26 | -31.6 |
| Coconut Products | 166 | 266 | 209 | 205 | 356 | 352 | 16.2 |
| Spices | 207 | 235 | 256 | 355 | 265 | 378 | 12.8 |
| Minor Agricultural Products | 72 | 89 | 76 | 101 | 165 | 161 | 17.5 |
| Other Agricultural Products | 248 | 241 | 254 | 306 | 334 | 225 | -1.9 |
| Industrial Export | 6,096 | 7,992 | 7,371 | 7,749 | 8,262 | 7,976 | 5.5 |
| Textiles and Garment | 3,356 | 4,191 | 3,991 | 4,508 | 4,930 | 4,825 | 7.5 |
| Rubber Products | 568 | 885 | 859 | 888 | 890 | 761 | 6.0 |
| Petroleum Products | 263 | 553 | 463 | 428 | 338 | 372 | 7.1 |
| Gem, Diamond and Jewellery | 409 | 532 | 559 | 446 | 394 | 331 | -4.1 |
| Other Industrial Products | 1,500 | 1,832 | 1,499 | 1,480 | 1,711 | 1,686 | 2.4 |
| Mineral Exports | 24 | 33 | 61 | 52 | 60 | 28 | 3.1 |
| Unclassified Exports | 199 | 7 | 10 | 12 | 15 | 18 | -38.0 |
| Total Exports | 8,626 | 10,559 | 9,774 | 10,394 | 11,130 | 10,505 | 4.0 |

Source: PIP

In the aforementioned World Bank study, eight sectors were selected⁹⁰ as promising sectors. Further, taking into account of the sectors mentioned in interviews with the BOI (staffs who joined Harvard University industry identify project)⁹¹, EDB⁹² and hearings at the Ceylon Chamber of Commerce (CCC)⁹³, the following 11 suitable sectors were selected as showing promise in the manufacturing and service sectors:

Table 4-7 Summary of previous researches and interviews about Sri Lanka's potential industries

| Sector | World Bank ⁹⁴ | BOI (Harvard) | EDB | CCC |
|-------------------------|--------------------------|------------------|-----|-----|
| Textile, Apparel | ✓ | | | |
| Food Processing | ✓ | | ✓ | ✓ |
| Rubber | ✓ | | | |
| Electronics & Electrics | | | ✓ | |
| Auto Parts | ✓ | ✓ | ✓ | |
| Pharmaceutical | ✓ | ✓ | | |
| Medical Device | ✓ | ✓ | | |
| Solar Panel | | ✓ | | |
| IT/BPM | ✓ | | | ✓ |
| Logistics | ✓ | ✓ | | ✓ |
| Tourism | ✓ | ✓ | | ✓ |

Source: Prepared by the Survey team based on the interviews to the World Bank, BOI, EDB and CCC

Table 4-8 shows the grouping of industries by its development. All three service industries have been already developed as major export industries. On the other hand, the manufacturing industries are classified into the current main export industry, the industry with small exporting scale but growing, and the industry to be cultivated in the future which is yet to be manufactured / exported.

⁹⁰ Based on the World Bank survey. During the interview, it was confirmed that the life science was combination of pharmaceutical and medical device, hence in this survey they are divided.

⁹¹ Through the interview with the BOI, it was confirmed that in the initial Harvard University project, 5 industries; automobile parts, pharmaceutical, medical devices, solar panel, tourism (apartment hotels) were selected, but the BO team added logistics later on.

⁹² From the interview with the EDB

⁹³ From the interview with the CCC

⁹⁴ According to the interview to the World Bank, survey team confirmed that "Life Science" means "Pharmaceutical" and "Medical Devices". Therefore, we divided into two sectors at this section.

Table 4-8 Current Export/Manufacturing Status of Sri Lanka’s potential industries

| | Main Export Industry | Industry under cultivation with a small export scale | Industry to be cultivated in the future which is yet to be manufactured / exported |
|---------------|---|---|---|
| Manufacturing | <ul style="list-style-type: none"> • Apparel/Textile • Food Processing • Rubber products | <ul style="list-style-type: none"> • Electronics & Electrics • Auto Parts | <ul style="list-style-type: none"> • Pharmaceutical • Medical Device • Solar Panel |
| Services | <ul style="list-style-type: none"> • IT/BPM • Logistics • Tourism | | |

Source: Prepared by the Survey team

From the next section, the 11 industries extracted above (4.2.2 and 4.2.3) will be analysed. Then, in 4.2.4, from the 11 promising industries above, we will discuss potential industries with already existing pioneer investors, and has a large supporting industry structure. For industries that are already exporting, detailed business environment analysis of each industry was conducted. On the other hand, for industries that have hardly exported or manufactured at present, we have reviewed the current situation and the strengths of Sri Lanka.

4.2.2 Business environment analysis of each promising industry (current export industries)

This section will assess industries already generating major exports of Sri Lanka from 11 nominated industries in previous section.

(1) Apparel and Textile manufacturing

① Country comparison

Textile manufacturing is Sri Lanka’s top exporting industry. A comparison with other top exporting countries is given in the table below.⁹⁵

With its relatively low wages, Sri Lanka has an advantage in production of high-end products. Meanwhile, Sri Lanka lags behind competitors in the upstream and middle stream industries such as fabric manufacturing, spinning, weaving, knitting, and dyeing capacities; currently, they are basically dependent upon imports for fabrics and textile⁹⁶. Given the extremely small working population, however, apparel sector manufacturing will need to be mechanized and streamlined for further growth and export development.

⁹⁵ In selecting countries for the comparison, we first looked at countries exporting more in value than Sri Lanka for the particular export item (in this case, apparels), giving preference to neighbouring countries in Asia and other regions expected to be highly likely competition. Particular care was taken to include for comparison those countries specifically mentioned by local industrial groups and elsewhere as competing countries during the field study. The same is true for all subsequent sectors.

⁹⁶ However, some companies have confirmed that upstream production have already been carried out.

Table 4-9 Comparison with other countries in apparel sector

| | Sri Lanka | China | Bangladesh | Vietnam | India | Indonesia |
|--|---|---|---|--|--|---|
| Population (People) | 20 million | 1.37 billion | 160 million | 90 million | 1.31 billion | 250 million |
| Labour wages (manufacturing industry, worker, month) (USD) | 141 | 465 | 99 | 180 | 239 | 255 |
| Export value (USD million) | 4,547 | 162,348 | 30,515 | 224 | 17,130 | 7,283 |
| Export value ranking | 17 th | 1 st | 2 nd | 3 rd | 6 th | 13 th |
| Major markets (main export destinations) | Europe, USA | USA, Japan, Hong Kong | Europe, USA | USA, Japan, Korea | | USA, Germany, Japan |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTASAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia • BIMSTEC | <ul style="list-style-type: none"> • FTA: Australia, Korea, Switzerland, Iceland, Costa Rica, Peru, Singapore, New Zealand, Chile, Pakistan, ASEAN • CEPA • APTA | <ul style="list-style-type: none"> • SAFTA • SAPTA • APTA • BIMSTEC • GTP • PTA among D-8 • Non-tariff access: EU, Canada, Australia, Norway, Switzerland, New Zealand, USA, Turkey, China | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China | <ul style="list-style-type: none"> • FTA: Sri Lanka, ASEAN • PTA: Chile, Afghanistan, Mercosur • CEPA: Japan, Korea • CECA: Singapore, Malaysia • Economic Cooperation Agreement: Finland • Trade Agreement: Africa, Bhutan, Nepal • SAPTA • SAFTA • APTA • SATIS • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • PTA among D-8 |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures based on Article 17 of BOI Act 1978 No.4. | <ul style="list-style-type: none"> • The spinning industry is subject to the preferential policies of foreign | <ul style="list-style-type: none"> • Ministry of Commerce provides a fixed rate subsidy to the | <ul style="list-style-type: none"> • In the case of new investment or expansion investment | <ul style="list-style-type: none"> Some provinces have preferential treatment specialized for apparel industry. | <ul style="list-style-type: none"> • After applying to BKPM, investor can receive preferential |

| | Sri Lanka | China | Bangladesh | Vietnam | India | Indonesia |
|-------------------------------------|---|---|---|---|--|---|
| | <p>Tax exempt from capital goods and tariffs on raw materials is applied for companies exporting 60% or more of the products in apparel industry,</p> <ul style="list-style-type: none"> Exchange exemption of export oriented industry (including companies exporting 60% or more of manufactured goods in the Apparel industry) under Article 17 of the BOI Act. | <p>companies and can receive benefits such as reduction of corporate tax rate and additional deduction of R & D expenses.</p> <ul style="list-style-type: none"> Priority industries including spinning industry can apply reduction of fixed asset's useful life or accelerated depreciation in calculating corporate income tax. | <p>export value of products including apparels. (The subsidy rate for 2015-2016 is 4% for domestic clothing items and 12.5% for leather products)</p> | <p>(*improvement of manufacturing capacity by more than 20%) in supporting industry including apparel industry, the corporate tax rate will be reduced to 10% for 15 years. In addition, investors can receive import tax exemption for fixed assets, preferential interest rate on borrowing of Vietnam Dong, support for R & D expenses, etc.</p> | <p>(i.e.) partial reimbursement for land acquisition expenses, reduction of stamp duty on land lease, preferential treatment for electricity fee, preferential treatment for taxation, renewed area subsidies, and preferential treatment for super-large projects. When export garment manufacturers import materials, tax exempt items are set.</p> | <p>treatment for corporate income tax on investment of the apparel industry. Up to 30% of the investment can be deducted from taxable income for 6 years at 5% per year. Furthermore, it can shorten the useful life to 1/2 of usual.</p> |
| Value Chain Situation ⁹⁷ | (Upstream), Downstream | Upstream, Downstream | (Upstream), Downstream | (Upstream), Downstream | Upstream, Downstream | Upstream, Downstream |
| Supplier of Textiles | India, Pakistan, China, Hong Kong | Domestic, Japan, Korea | India, Pakistan, China | China, Korea, Japan | Domestic | Domestic, China, Korea, Hong Kong |
| Comparative advantage | Sri Lanka has high technology and strengths in the production of high- | China can correspond widely from high-end to low-end. The shift of | Large and inexpensive labour force is a strength, and mass production | Main strengths are: stable productivity, wide range of products, high | India has strengths in textile/ fabric production, and has a solid value chain | Indonesia has strengths on integrated production system |

⁹⁷ Upstream: Producing materials such as textile, knit, yarn, and related processes such as dyeing, printing etc. Downstream: Sewing. Of the major apparel exporting countries, Cambodia, Myanmar, the Philippines, and Laos are examples that do not have domestic upstream processes. Among them, countries within top 20 apparel exporters are Cambodia (15th) only.

| | Sri Lanka | China | Bangladesh | Vietnam | India | Indonesia |
|--|--|--|---|--|---|--------------------------|
| | end products. In recent years, efforts on production of upstream processes such as materials etc. are also seen, mainly by apparel giants. | production bases to other countries is ongoing, but China remains still as the world's largest Apparel industry country. | of low price range products are mainstream in Bangladesh. | quality, and skilful work force. Production for middle-class customers is mainstream in Vietnam. | from upstream to downstream. Some countries pay attention to India as a supplier of textiles / fabrics. | from material to sewing. |

Source: Prepared by the Survey team based on various sources

② Sri Lanka's position in the value chain

On the textile/apparel manufacturing value chain, Sri Lanka already handles the processes of design, development, and sewing of clothes. Sri Lanka's apparel industry has its strength in small- to medium-volume production of high value added items requiring advanced skills like three-dimensional cutting and sewing of suits or female undergarments, rather than mass production of low value-added products such as T-shirts.

It is also suggested by the JAAFSL, the industry association, that the association explores possibilities of the production of the upstream such as fabric spinning, cloth weaving and knitting, and dyeing in Sri Lanka.⁹⁸

Meanwhile, several of Sri Lanka's domestic major apparel enterprises have already started production of materials, from planning and development to manufacturing. For example, MAS Holdings operates MAS Fabric Park, the only private export processing zone in Sri Lanka. In MAS Fabric Park, necessary infrastructure for apparel and textile manufacturing, from upstream to downstream, are prepared⁹⁹. The main tenants of MAS Fabric Park are MAS affiliates. Traditionally, MAS imported materials from other Asian countries such as China and processed them in Sri Lanka, and was involved only in the downstream process. However, in order to enjoy the benefits of FTAs, it is important to give value added in the domestic process¹⁰⁰, so MAS began to work on material manufacturing as well.

At present, upstream and downstream processes such as material planning and development to spinning and fabric production are also being implemented in Sri Lanka. In particular, Sri Lanka has strengths in the planning, development and manufacture of functional materials such as sportswear and swimming suit. Under these circumstances, Sri Lanka is the world's second largest production base of NIKE, the largest customer of MAS. Sri Lanka is also the world's No. 1 production base for Victoria's Secret, which is also a main customer of MAS¹⁰¹.

⁹⁸ Interviews at JAAFSL conducted in April 2017.

⁹⁹ Specifically, water treatment facilities are fully equipped, and MAS set their own criteria that is even stricter than Sri Lanka domestic environmental emission standards.

¹⁰⁰ For example, at the ISFTA, an FTA with India, it is necessary to grant added value of 35% when exporting without tariff. (If importing raw materials from India, added value in Sri Lanka needs to be 25% or more).

¹⁰¹ Interview at MAS Fabric Park (May 2017)

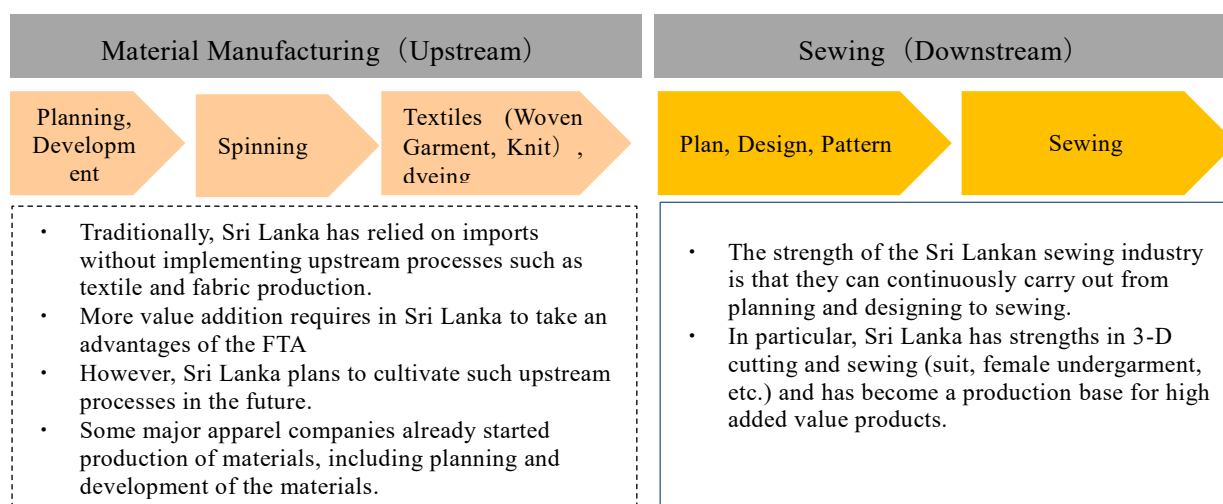


Figure 4-5 Apparel Value Chain and Sri Lanka's Position

Source : Prepared by the Survey team

③ Significance of and barriers to entry of foreign investments

With a history of Western apparel giants¹⁰² having their product manufactured in Sri Lanka for worldwide export, the Sri Lanka apparel industry had exported much of its product to North America and Europe. To date, the progress of such FDI has driven the expansion of Sri Lanka apparel exports and its industry capabilities. However, JAAFSL expressed desires to diversify their export destinations given the overly relying on US and European exporters, saying the industry wants to develop in other markets with FDI from Japan and other countries.¹⁰³

Also, JAAFSL is motivated to reinforce production capacities of upstream of textile manufacturing. The JAAFSL is already trying to solicit foreign investments in upstream of textile production.¹⁰⁴ Some major apparel companies such as MAS have already expanded to upstream production, but when looking at Sri Lanka as a whole, upstream industry is still in the process of being developed. For this reason, it is considered effective for future development of the apparel industry of the country to carry out material production including high function materials strengthen the upstream field of Sri Lanka's apparel industry.

Meanwhile, the attractiveness of Sri Lankan apparel industry investment is as follows. First, Sri Lanka had already adopted high technology into apparel industry that can manufacture high function& high value products. Local apparel companies are experienced to contract with major European and American companies' outsource production, and such local companies have the ability to implement from product design and manufacturing. In addition, although labour cost is not as inexpensive as neighbouring countries, Sri Lanka offers reasonable cost level considering the skills and technology. Also, as there are many local garment factories engaged in contract manufacturing by Western apparel companies, it would be meaningful to set up textile/ material manufacturing bases for these apparel production bases.

¹⁰² Examples: Victoria's Secret, GAP, Nike, Triumph, Ann Taylor, Abercrombie & Fitch, etc.

¹⁰³ Interviews at JAAFSL conducted in April 2017.

¹⁰⁴ Ibid.

Furthermore, it is confirmed that GSP+¹⁰⁵ is reapplied to Sri Lanka from May 2017. Export of apparel products to Europe is expected to increase, so the advantage of Sri Lanka as an export base for Europe and North America is growing. However, GSP+ is not applied to the countries that are categorized as high-middle-income countries¹⁰⁶ for three consecutive years. As Sri Lanka's GNI per capita is about USD 3,800, it is considered a matter of time to become a high-middle income country. Therefore, Sri Lanka needs to be prepared for the market access without the status of GSP+ within 4 to 5 years.

④ Proposals and current efforts for promoting apparel manufacturing in the future

The Survey team's proposals for promoting the Sri Lanka apparel manufacturing sector are as follows:

- Improve efficiency by mechanization; producing Expanding production of high value-added products
- Expansion of production capacity through establishment of new factory (Including relocation of labour intensive process to villages)
- Development of upstream industry
- Diversification of export destinations
- Diversification of export/production items products; manufacturing high value-added products

Sri Lanka's plans regarding each of the above proposals items are as described in the following chart.

Table 4-10 Proposal and Correspondence situation of Apparel Industry

4: Very Good 3: Good 2: Fair 1: Bad

| Proposal | Correspondence Situation ¹⁰⁷ | Evaluation |
|---|---|------------|
| Improve efficiency by mechanization | JAAFSL has a plan to introduce advanced technology, promote mechanization to increase efficiency, and expand production. Some companies have already promoted mechanization by introducing 3D printers etc. | 3 |
| Expansion of production capacity through establishment of new factory | JAAFSL has a plan to establish apparel factories in areas with high poverty rate and create new employment. JAAFS is currently requesting government support such as land use for business development to rural areas. | 3 |
| Development of upstream industry | JAAFSL is aiming to expand more upstream processes such as spinning, dyeing and fabric production. Some major apparel companies already started textile and fabric production | 3 |
| Diversification of export destinations | Although the dependency rate on North America and UK is improving, dependency on these two countries is still high. JAAFSL is also developing other markets such as China, Australia, Russia and others, to diversify export destination. | 3 |
| Diversification of export / production items, manufacturing high value added products | The current main products are clothing items. Diversification of production items has not been considered yet. | 2 |

Source: Prepared by the Survey team

¹⁰⁵ A type of Generalized Scheme of Preferences (GSP) provided by the EU. Granting further preferential measures to developing countries / regions that have ratified and comply with a series of international treaties relating to sustainable development and human rights protection. Regarding beneficiary countries of GSP+, even for the sensitive items, customs duties are exempted if certain conditions are satisfied.

¹⁰⁶ It is classified by the World Bank based on GNI per capita, and the upper middle-income economies, set to 1 July 2016, is the countries with a per capita GNI of more than \$ 4,036.

¹⁰⁷ Based on interview to JAAFSL

(2) Food Processing

① Country comparison

The Sri Lankan food processing sector's major export items have been black tea, spices, and coconut.

Compared to other sectors, food processing industry has been slow to develop high value-added products. Export growth is stagnant for all products due to weak competitiveness against other countries in international markets. Productivity of agricultural products is also stagnating. To increase exports, the sector needs to improve its productivity, streamline value chain, and implement high value-addition domestically.

Table 4-11 Comparison with other countries in Food Processing sector

| | Sri Lanka | Vietnam | China | India | Indonesia |
|--|---|--|---|--|---|
| Population (People) | 20 million | 90 million | 1.37 billion | 1.31 billion | 250 million |
| Labour wages (manufacturing industry, worker, month) (USD) | 141 | 180 | 465 | 239 | 255 |
| Export value (USD million) | Tea, Coffee, Spices: 1,666 Processed Nuts (Coconuts etc.): 144 | Tea, Coffee, Spices: 4,005 Processed Nuts (Coconuts etc.): 1,262 | Tea, Coffee, Spices: 2,537 Processed Nuts (Coconuts etc.): 318 | Tea, Coffee, Spices: 2,919 Processed Nuts (Coconuts etc.): 877 | Tea, Coffee, Spices: 2,196 Processed Nuts (Coconuts etc.): 559 |
| Major markets (main export destinations) | Tea: Middle East, Russia, Japan, China Spice: India, Latin America, USA Other food: Middle East, USA, India | Tea: Pakistan, Russia, China | Tea: Africa (Morocco, Algeria, etc.), USA, Russia, Japan | Tea: UAE, USA, China, Singapore Spice: USA, Vietnam, China, Indonesia | Tea: Russia, UK, Pakistan Spice: USA, Germany, Holland, Singapore, Japan |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia) • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China | <ul style="list-style-type: none"> • FTA: Australia, Korea, Switzerland, Iceland, Costa Rica, Peru, Singapore, New Zealand, Chile, Pakistan, ASEAN • CEPA • APTA | <ul style="list-style-type: none"> • FTA: Sri Lanka, ASEAN • PTA: Chile, Afghanistan, Mercosur • CEPA: Japan, Korea • CECA: Singapore, Malaysia • Economic Cooperation Agreement: Finland • Trade Agreement: Africa, Bhutan, Nepal • SAPTA • SAFTA • APTA • SATIS • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • PTA among D-8 countries |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures according to Article 17 of BOI Act 1978 No.4. Tax exempt from capital goods and tariffs on raw materials | <ul style="list-style-type: none"> • As food processing industry is included in the special incentive investment field, investors can receive incentive measures such | <ul style="list-style-type: none"> • The food processing industry is subject to the preferential policies of foreign-affiliated companies and can receive benefits such as | <ul style="list-style-type: none"> • The central government provides subsidies for the establishment and modernization of food processing companies, | <ul style="list-style-type: none"> • As food processing industry is included in the special incentive investment field, investors can receive incentive measures such |

| | Sri Lanka | Vietnam | China | India | Indonesia |
|-----------------------|--|---|---|--|--|
| | is applied for companies exporting 90% or more of the products in manufacturing industry. • Exchange exemption of export oriented industry (including companies exporting 90% or more of manufactured goods in the manufacturing industry) under Article 17 of the BOI Act. | as reduction of corporate tax rate during the implementation period of investment project, exemption of import tax of fixed assets, reduction and exemption of land rent and land use fee. | reduction of corporate tax rate and additional deduction of R & D expenses. | and introduction of refrigerated cars, etc. | as reduction of corporate tax rate during the implementation period, exemption of import tax of fixed assets, reduction and exemption of land rent and land use fee. |
| Value Chain Situation | Raw Materials Procurement~ Processing/ Manufacturing | Raw Materials Procurement~ Processing/ Manufacturing | Raw Materials Procurement~ Processing/ Manufacturing | Raw Materials Procurement~ Processing/ Manufacturing | Raw Materials Procurement~ Processing/ Manufacturing |
| Comparative advantage | Sri Lanka is one of the world's leading tea producers, and tea leaves are major export product. On the other hand, depending on items such as spices, quality may be a bottleneck and it may not be possible to fully exploit the export market. | Although Vietnam is one of the world's leading tea exporting countries, its brand power is weak. Therefore, Vietnam is mainly focusing on mass exports of inexpensive tea leaves for blended tea. | China is one of the world's leading tea exporters and exports a lot of green tea in particular. However, in recent years, export tend to decrease due to declining price competitiveness. | Due to the low production cost, India has strong competitiveness from before. In recent years, India have strengthened export competitiveness through efforts to improve quality such as acquisition of international standards, adoption of new technology etc. | Indonesia has strengths in exporting palm oil in particular. Although it is the world's 7th largest producer of tea, imports are expanding mainly from high-grade tea due to inadequate development of processing field. |

Source: Prepared by the Survey team based on Various Sources

② Sri Lanka’s position in the value chain

Food processing industry in Sri Lanka is an exception among other industries because processes complete domestically, from sourcing raw materials to processing and manufacturing. Sri Lanka has a particularly strong global presence in black tea. By occupying 19% of global market share, Sri Lanka is the world’s third largest exporter. In contrast, spices and coconut products exports face quality management issues and Sri Lankan manufacturers cannot help to export with lower value added state and loosing competencies in the market.

Some cases were explained regarding spice industry by the SAPPTA (the Spices and Allied Products Producers' and Traders' Association), a local spice industry group. First, although the quality of products such as ingredients and fragrances of Sri Lankan spices is high, there is no business operators with sterilizing equipment as required by Europe and the United States, so it is an issue that sterilization processes meeting a quality standard of Europe and the United States cannot be done domestically. In addition, because the productivity is low and the production volume is limited, production volume control is difficult to negotiate export to Europe and the United States. Also, an absence of commercial relationship with major export destinations makes it difficult for industry to explore export opportunities.

For this reason, spices other than cinnamon are currently being exported to India in raw and bulk, where they are processed and powdered, mixed and re-exported to Europe and the United States. SAPPTA has a strong desire to integrate value-adding processes domestically, and is willing to trade directly with the European and US markets at better prices.

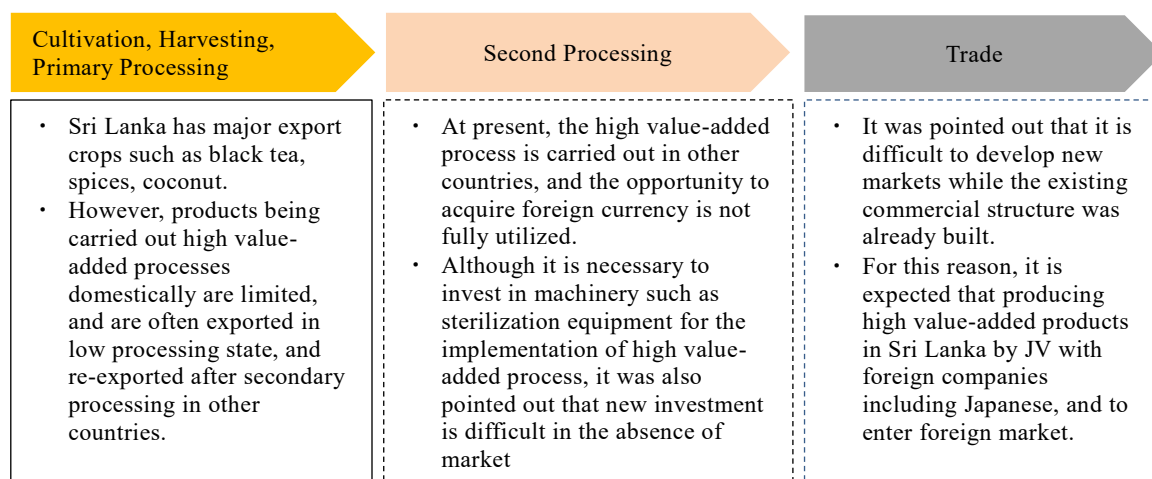


Figure 4-6 Food Processing Value Chain and Sri Lanka’s Position

Source: Prepared by the Survey team

③ Significance of and barriers to entry of foreign investments

As stated in the preceding section, in order to reinforce export capacity, it is necessary to implement high-value-adding process domestically. At the same time, improving productivity of agricultural crops and quality by mechanization is also needed.

In order to acquire such technologies and market opportunities, local companies are expecting the establishment of processing plants and mechanization at the local value-addition process by composing joint ventures with the investment of foreign-affiliated companies, and developing new markets.

As for joint venture partners for such FDI, for example, SAPPTA recommended partnering with large-scale plantation companies because they have sufficient human resources and funds available for mechanization. Benefits for investors would be a relatively cheap labour, and highly nutritious products. Upon improvement of production capacity and quality management measures & practices, the industry could aim at exporting to developed countries.

④ Proposals and current efforts for promoting food processing sector in the future

The Survey team’s proposals for promoting Sri Lankan food processing sector are as follows:

- Implementation of high value-addition processes domestically
- Improving productivity of the agriculture
- Enhancement of human resource development agencies in the agricultural field
- Diversification of export destinations
- Improving certifying quality, achieving a quality level required by Europe and the United States

Sri Lanka’s plans regarding each of the above proposals items are as described in the following chart.

Table 4-12 Proposal and Correspondence situation of Food Processing Industry

4: Very Good 3: Good 2: Fair 1: Bad

| Proposal | Correspondence Situation ¹⁰⁸ | Evaluation |
|--|---|------------|
| Implementation of high value-added process domestically | For some items, high value-added processes are implemented domestically and exported from Sri Lanka. However, some items are exported as bulk in an unprocessed form, and high value-added processes are carried out in other countries and re-exported to other countries. For this reason, it is necessary to introduce technologies and machinery that can carry out high value-added processes domestically. However, as the market is uncertain, new investment has not progressed much. | 2 |
| Improving productivity of the agriculture | Insufficient production for export is one of the issues. Local industry organizations are also expecting for the technology transformation of productivity improvement that is expected by the Japanese government, universities and companies ¹⁰⁹ . | 1 |
| Enhancement of human resource development agencies in the agricultural field, strengthening cooperation with other countries | Compared with other major industries, enhancement of human resource development agencies in the agricultural field are delayed. Possibilities for cooperation with educational institutions arose, but no concrete improvements have been achieved yet. | 2 |
| Diversification of export destinations | Taking tea as an example, export destination is already diverse. However, there is no market access for high value-added | 2 |

¹⁰⁸ Corresponding situation based on interview with SLFPA and SAPPTA.

¹⁰⁹ Interview to SLFPA and SAPPTA (April, May 2017).

| Proposal | Correspondence Situation ¹⁰⁸ | Evaluation |
|--|---|------------|
| | products for some categories, and there are many cases where products are exported at low prices for reprocessing in other countries. Sri Lanka tries to attract foreign investors who conduct processing of high value-added process domestically and explore new market together, though they are not able to grasp a clue for concrete solution yet. | |
| Improving and achieve quality level required by Europe and the United States | The importance of quality improvement has been recognized. However, it was mentioned by SLFPA that even if new investment was made to solve the problem, it is difficult to deal with the issue in the absence of secured sales destination. | 2 |

Source: Prepared by the Survey team

(3) Rubber

① Country Comparison

While exports of Sri Lankan natural rubber have been stagnating in recent years, exports of the processed rubber products are increasing. In this light, natural rubber can be considered as a successful value added agricultural products.

The competitive landscape in rubber is changing—Malaysia, once the world’s biggest natural rubber exporter, is ramping down its natural rubber cultivation, and is now replaced by Thailand as leading exporter. Amidst this, Sri Lanka has established a unique position with the world’s leading share for solid tires, world’s fifth largest share for rubber groves.

On the other hand, the domestic production of natural rubber is stagnating, and in order to support the growing rubber processing industry (downstream industry), promotion of natural rubber production in the upstream field is essential, especially increase in yield of plantation is expected as a practical solution toward improving entire estate’s productivity.

Table 4-13 Comparison with other countries in Rubber sector

| | Sri Lanka | Thailand | Indonesia | Malaysia |
|--|---|---|---|--|
| Population (People) | 20 million | 60 million | 250 million | 30 million |
| Labour wages (manufacturing industry, worker, month) (USD) | 141 | 344 | 255 | 311 |
| Export value (USD billion) | 0.7 | 8.28.2 | 6.96.9 | 2.22.2 |
| Export value ranking | 19 th | 1 st | 2 nd | 3 rd |
| Major markets (main export destinations) | USA, Europe, Pakistan, Malaysia, India, Japan | China, Malaysia, Japan | USA, China, Japan | China, Germany |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia) • BIMSTEC | <ul style="list-style-type: none"> • CEPT • GSTP • FTAs entered into force by Thailand among the FTAs signed by ASEAN: Japan, Australia, New Zealand, Korea, China • FTA: Peru, Chile • GSP donor country: Australia, Japan, New Zealand, Norway, Switzerland, USA, Russia | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Indonesia among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • PTA among D-8 | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Malaysia among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • FTA: Chile, Turkey, EU • Trade Preferences: OIC¹¹⁰ • PTA among D-8 • GSP donor country: Norway, Switzerland, Liechtenstein, Belarus, Kazakhstan, Russia |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures according to Article 17 of BOI Act 1978 No.4. Tax exempt from capital goods and tariffs on raw materials is applied for companies exporting 90% or | <ul style="list-style-type: none"> • Rubber products industry is included in Thailand's investment promotion industry. • For projects that satisfy prescribed approval standards among investment promotion industries, benefits such as | <ul style="list-style-type: none"> • After applying to BKPM, investor can receive preferential treatment for income tax on investment in agro processing and petrochemical industry. Up to 30% of the investment amount can be deducted from taxable | <ul style="list-style-type: none"> • Investment promotion industry in Malaysia are manufacturing, agriculture and tourism etc., and manufacturing of rubber products is included in the investment promotion industries. If it is an investment promotion |

¹¹⁰ OIC Member States: : Malaysia, Jordan, Oman, Qatar, Turkey, Arab Asian Nations, Saudi Arabia, Somalia, Syria

| | Sri Lanka | Thailand | Indonesia | Malaysia |
|-----------------------|--|--|---|---|
| | <p>more of the products in manufacturing industry.</p> <ul style="list-style-type: none"> Exchange exemption of export oriented industry (including companies exporting 90% or more of manufactured goods in the manufacturing industry) under Article 17 of the BOI Act. | <p>exemption from corporate tax and tariffs are provided. These projects are divided into two types, Group A and B, according to the importance of industry, and receive different level of benefits accordingly.</p> <ul style="list-style-type: none"> For investment in the southern border prefecture, benefits such as exemption of corporate tax and custom duties are provided, based on certain conditions. | <p>income for 6 years at 5% per year. Furthermore, it can shorten the useful life to 1/2 of usual.</p> | <p>industry, tax incentives such as investment deduction (ITA, 60% of the initial capital expenditure can be deducted from income under corporate tax law) or reinvestment deduction (RA, 3 years after the start of operation, 60% of the reinvested amount to expand existing business etc. can be deducted from the income arising from the project) are available.</p> <ul style="list-style-type: none"> If it is a state-of-the-art project or that has a major impact on the national economy, and if it is recognized as a pioneer status, 70% of corporate tax will be exempted for 5 years |
| Value Chain Situation | Raw Materials Procurement ~ Processing/ Manufacturing | Raw Materials Procurement ~ Processing/ Manufacturing | Raw Materials Procurement ~ Processing/ Manufacturing | Raw Materials Procurement ~ Processing/ Manufacturing |
| Comparative Advantage | <p>1st place of worldwide market share of solid tires. 5th place of worldwide market share of rubber gloves. However, low productivity and the stagnation of the natural rubber industry in recent years are concerned.</p> | <p>Thailand is the largest natural rubber production country which accounts for about 80% of the global production of natural rubber. As Thailand is also a production base for automobiles, there are lots of investments for manufacturing automotive parts such as tires. As such, Thailand has superiority in the structure of the value chain.</p> | <p>With vast land and population, capacity increase by expanding cultivation area is relatively easy. However, productivity per unit area is low.</p> | <p>Previously it was the world leader in natural rubber production, but in recent years it has been shifting production to palm oil.</p> |

Source: Prepared by the Survey team based on Various Sources

② Sri Lanka’s Position in the Value Chain

The Sri Lankan rubber processing sector is capable of completing all processes including high value-addition processes domestically. Sri Lanka-made rubber products are recognized for their quality and durability, and approximately 70% of domestically-produced natural rubber is exported after processed domestically. Tire is the major rubber processing products these days. According to the export performance of 2015, the tire sector accounted for about 60% of the total rubber export value (USD 786 million). The second largest is rubber gloves with USD 164 million, accounting for about 20% of the total. With these two products account for about 80% of the total rubber exports, diversification of exported products is an issue. Other items constitute the remaining 20%, which includes automobile/ mechanical parts, mobile phone products, floor mats and such.

While the downstream of rubber industry steadily being developed, the concern is the decline of the upstream industry. In the rubber exports of Sri Lanka, while the rubber processing industry is growing steadily, the upstream natural rubber industry is stagnating. This involves problems such as a shortage of workers (including increased labour costs) and a low productivity of the traditional natural rubber industry. Under such circumstances, it has shown a movement such as diversification from natural rubber plantation to other crops (spices etc.) on the producer side. In fact, some rubber raw materials processed in Sri Lanka are imported.

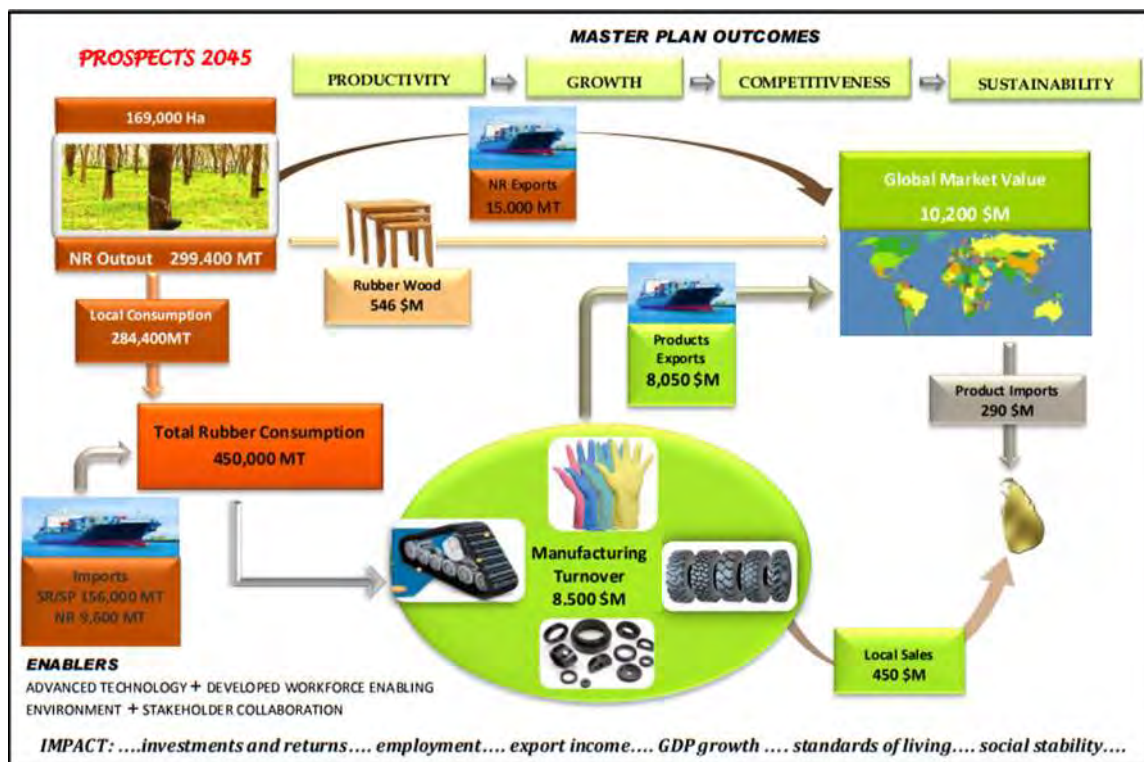


Figure 4-7 Overview of Sri Lankan Rubber Industry

Source: Sri Lanka Rubber Secretariat, “Sri Lanka Rubber Industry Master Plan 2017-2026”

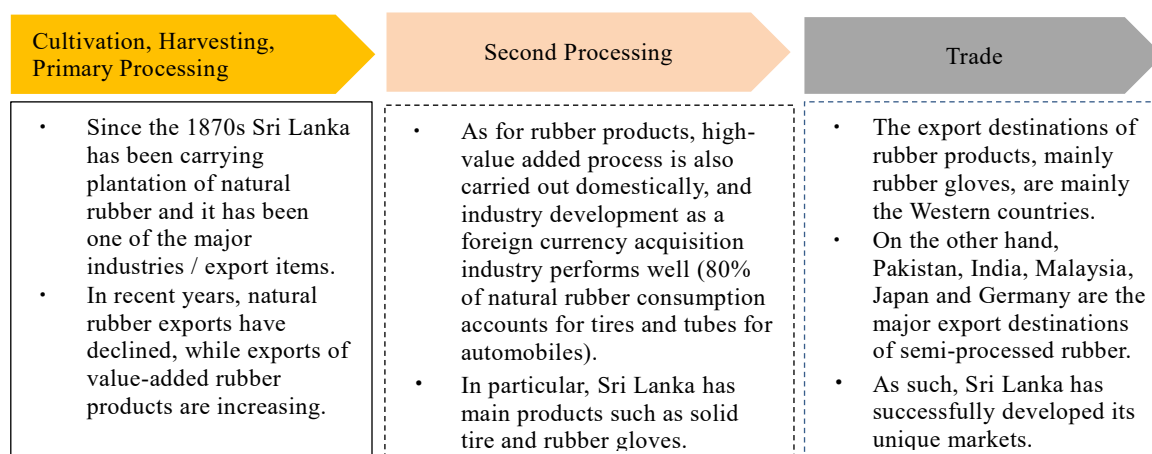


Figure 4-8 Food Processing Value Chain and Sri Lanka's Position

Source: Prepared by the Survey team

③ Significance of and barriers to entry of foreign investments

80% of natural rubber is used for vehicle tires and tubes. Vigorous internal training in the automotive rubber part manufacturing sector with foreign investments has been promoting the Sri Lankan rubber industry. Specifically, Sri Lanka exports rubber auto parts and products including tires, floor mats, rubber seals, rubber bumpers, dust covers, and mud flaps.

Industry is now facing a low productivity yield of domestic natural rubber to retain products' competitiveness at the value addition and processing. Rubber processing industry's promotion and development has to take into account stability of raw material supply through yield improvements as well.

On the other hand, an advantage of investment in Sri Lanka in rubber processing is the availability of relatively inexpensive labour force with skilled capability of high value addition rubber processing. As such, Sri Lanka is considered as a promising processing base for export rubber products.

④ Proposals and current efforts for promoting rubber product sector in the future

Rubber processing is a key sector in Sri Lanka to acquire foreign currency. For the further promotion of the rubber processing industry, based on existing issues, there are sector promotion plans such as the "Rubber Industry Master Plan 2017-2026". The following five points are suggested by the Survey team for the promotion of Sri Lanka's rubber processing industry.

- Improving productivity of natural rubber
- Promoting mechanization
- Enhancement of human resource development agencies in the agricultural field
- Diversification of export destinations
- Diversification of export products

Sri Lanka's plans regarding each of the above proposals items are as described in the following chart.

Table 4-14 Proposal and Correspondence situation of Rubber Industry

4:Very Good 3:Good 2:Fair 1:Bad

| Proposal | Correspondence Situation ¹¹¹ | Evaluation |
|--|---|------------|
| Improving productivity of natural rubber | It is considered as a problem that it is not possible to harvest a sufficient amount of natural rubber for export since productivity is low. Therefore, efforts toward expanding the harvest of natural rubber are necessary. | 2 |
| Promoting mechanization | With the lack of people in the rubber industry as a whole, it is expected to improve efficiency by mechanization together with productivity improvement. | 1 |
| Enhancement of human resource development agencies in the agricultural field, strengthening cooperation with other countries | Compared with other major industries, enhancement of human resource development agencies in the agricultural field including rubber has been delayed. However there was a movement to seek possible cooperation with other countries' educational institutions, the prospects for concrete improvements has not yet established | 1 |
| Diversification of export products | Solid tires and rubber gloves account for 80% of the total export products, so the master plan aims to promote diversification of export products. | 2 |

Source: Prepared by the Survey team

(4) Electronics and Electrics

① Country Comparison

The electronics and electrics sector in Sri Lanka remains small with few players, and exports are far less than major exporting countries in the sector. Current major export items of the electronics and electrical industry are cables, transformers, discharge lamps and switches. However, rather than aspiring to be a base for mass production, Sri Lanka hopes to establish itself as small scale production centres for hi-tech and niche products in the global value chain.

¹¹¹ Corresponding situation based on interview with SLFPA and SAPPTA.

Table 4-15 Comparison with other countries in electronics and electrical sector

| | Sri Lanka | Vietnam | Malaysia | Thailand | Philippines |
|--|---|---|--|---|---|
| Population (People) | 20 million | 90 million | 30 million | 60 million | 100 million |
| Labour wages (manufacturing industry, worker, month) (USD) | 141 | 180 | 311 | 344 | 312 |
| Export value (USD billion) | 227 | 47,399 | 59,642 | 29,295 | 25,974 |
| Export value ranking | 73 rd | 9 th | 12 th | 14 th | 18 th |
| Major markets (main export destinations) | Europe, USA, India, China | China, Japan | China, Japan, Singapore | ASEAN, Japan, USA, China | China, Japan, USA |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia) • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Malaysia among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • FTA: Chile, Turkey, EU • Trade Preferences: OIC • PTA among D-8 • GSP donor country: Norway, Switzerland, Liechtenstein, Belarus, Kazakhstan, Russia | <ul style="list-style-type: none"> • CEPT • GSTP • FTAs entered into force by Thailand among the FTAs signed by ASEAN: Japan, Australia, New Zealand, Korea, China • FTA: Peru, Chile • GSP donor country: Australia, Japan, New Zealand, Norway, Switzerland, USA, Russia | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • FTA with EFTA |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures according to Article 17 of BOI Act 1978 No.4. Tax exempt from capital goods and tariffs on raw materials is applied for | <ul style="list-style-type: none"> • In the case of product production corresponding to information technology products and government-decided development priority products list, it falls under the supporting | <ul style="list-style-type: none"> • Investment promotion industry in Malaysia are manufacturing, agriculture and tourism etc., and manufacturing of electronics and electrical products is included in | <ul style="list-style-type: none"> • The electronics and electrical industry is included in Thailand's investment promotion industry. | <ul style="list-style-type: none"> • Among the priority investment fields described in the Philippine Investment Priorities Plan (IPP), the breakdown of manufacturing industry |

| | Sri Lanka | Vietnam | Malaysia | Thailand | Philippines |
|-----------------------|---|--|---|--|---|
| | <p>companies exporting 90% or more of the products in manufacturing industry.</p> <ul style="list-style-type: none"> • Exchange exemption of export oriented industry (including companies exporting 90% or more of manufactured goods in the manufacturing industry) under Article 17 of the BOI Act. | <p>industry and when new investment or expansion investment (*manufacturing capacity is improved by 20% or more) is carried out, corporate tax rate is reduced to 10% for 15 years. In addition, investors can receive import tax exemption for fixed assets, preferential interest rate on borrowing of Don, support for R & D expenses, etc.</p> <ul style="list-style-type: none"> • The electronics and electrical industries that do not fall under the above-mentioned category are still eligible for the investment preferential category, and investment promotion measures such as reducing corporate tax rates during the implementation period of investment projects, exemption from import duties on fixed assets, reduction and exemption of land rents and land use fees will be applied. | <p>the investment promotion industries. If it is an investment promotion industry, tax incentives such as investment deduction (ITA, 60% of the initial capital expenditure can be deducted from income under corporate tax law) or reinvestment deduction (RA, 3 years after the start of operation, 60% of the reinvested amount to expand existing business etc. can be deducted from the income arising from the project) are available.</p> <ul style="list-style-type: none"> • If it is a state-of-the-art project or that has a major impact on the national economy, and if it is recognized as a pioneer status, 70% of corporate tax will be exempted for 5 years | <ul style="list-style-type: none"> • For projects that satisfy prescribed approval standards among investment promotion industries, benefits such as exemption from corporate tax and tariffs are provided. These projects are divided into two types, Group A and B, according to the importance of industry, and receive different level of benefits accordingly. • For investment in the southern border prefecture, benefits such as exemption of corporate tax and custom duties are provided, based on certain conditions. | <p>does not include electronics and electric industry. (On the other hand, manufacturing of aerospace parts and designing of integrated circuits are included in the priority investment field.)</p> <ul style="list-style-type: none"> • Manufacturers of manufacturing industries exporting 100% in principle in the export processing zone (Eco Zone) can receive benefits such as exemption of corporate tax for a certain period of time. |
| Value Chain Situation | Assembly | Parts manufacturing, Assembly | Parts manufacturing, Assembly | Parts manufacturing, Assembly | Parts manufacturing, Assembly |

| | Sri Lanka | Vietnam | Malaysia | Thailand | Philippines |
|-----------------------|--|---|--|---|---|
| Supplier of Parts | | Domestic, Japan, China | Domestic, Japan, China | Domestic, Japan, China, ASEAN | Domestic, Japan, China, ASEAN |
| Comparative Advantage | With excellent talent and high technology of Sri Lanka, attracting FDI is expected to be promising. But at present, the company has not yet advanced much. | Relocation of production processes from China has become prominent in recent years, and Vietnam is the largest substitution destination from China to the ASEAN region. | Due to the good business environment, the electronics industry has accumulated in Malaysia. Many enterprises set up ASEAN regional headquarters in Malaysia. However, while progress of the other countries is severe, Malaysian electronics industry does not progress much. With such background, in recent years, there have been many withdrawals due to the rise in personnel expenses and the difficulty in securing human resources, resulting in consolidation to other bases. | Although new investment to Thailand is sluggish, as automobile / parts industry accumulates in Thailand, it is expected that electronics related parts industry further increase in the future as the electronics installation to automobiles progresses. | Abundant talent and benefits of PEZA Special Economic Zone are attractive. There is a competitiveness in manufacturing parts such as integrated circuits, semiconductors, HDD etc. than finished goods. However, supporting industries are underdeveloped, and parts and half-finished products to be assembled depend on imports |

Source: Prepared by the Survey team based on Various Sources

② Sri Lanka position in the value chain

Sri Lanka already has parts assembly, a prerequisite for global value chains, and has companies with small and medium production in place. However, supporting industries are undeveloped.

Table 4-16 shows the export performance of the electronics and electrical industry in 2015 for each product type.

Table 4-16 Sri Lanka’s Export Items and Value of Electronics and Electrical Sector

| Product Type | Export Value (Million USD) |
|--|----------------------------|
| Insulated Wires and Cables | 45.10 |
| Electrical Transformers | 42.09 |
| Discharge Lamps | 41.67 |
| Switches, Lamp Holders Boards & Panels | 33.08 |
| Tea Bagging, Packing, Cleaning, Weighing Machines | 12.80 |
| Telephone Sets, Audio/Video Equipment & Parts | 7.59 |
| Printer Circuits | 6.86 |
| Refrigerators & Freezers | 5.22 |
| Boilers, Piston Engines, Pumps & Vacuum Pumps | 2.15 |
| Automatic Data Processing Machines | 1.73 |
| Electronic Circuits, Transistors, Valves, Cathode Tubes etc. | 0.46 |
| Air-Condition Machines | 0.45 |
| Other Electrical & Electronic Products | 94.64 |
| TOTAL | 93.86 |

Source: EDB, “Disaggregated Export Performance 2006-2015)

As shown in the table above, various electronic and electrical products are manufactured in Sri Lanka. Major items are cables, transformers, discharge lamps and switches. However, since all of these electronic and electrical products are basically assembled only, parts are mostly imported. Therefore, development of supporting industries is strongly in need.

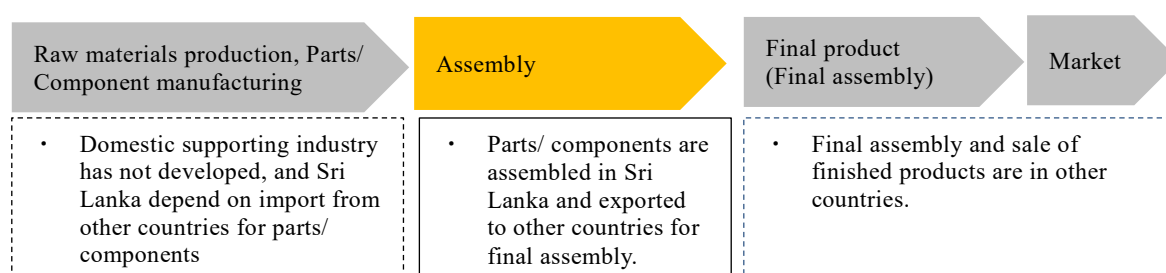


Figure 4-9 Electronics and Electrics Value Chain and Sri Lanka’s Position

Source: Prepared by the Survey team

③ Significance of and barriers to entry of foreign investments

The Sri Lankan electronics and electrical machinery industry has developed through the establishment of a factory of foreign companies, and the role of foreign investment was significant in nurturing the country's electronic and electrical industry. In particular, Sri Lanka has evolved as a parts assembly base in the global

value chain. On the other hand, supporting industries for manufacture remain small, and most materials are imported.

As for this reason, supporting industries have to be developed in Sri Lanka, although establishment of factories by foreign capital is usually effective in fostering new industries such as electronics and electrics, it has not yet happened. The major reason of this situation is due to difficulty of finding human resources, and other aspects such as negative images of the civil war.

On the other hand, advantage of foreign companies entering Sri Lanka is dexterous people with practical skills. Although the supply is scarce as discussed above, Sri Lankans labour demonstrate high ability of learning. Currently it highly depends on the efforts of the private sector to develop human resources, as it is difficult to secure steady supply of skilled people.

In order for Sri Lankan Electronics and Electrics industry to develop further, for example, foreign companies operating in ASEAN countries such as Thailand and Malaysia may possibly manufacture some processes in Sri Lanka.

According to Japanese companies that have already started their business in Sri Lanka, value chain is becoming globalized mainly thanks to air freight services such as DHL, and export destinations can be reached to North America, Europe, etc. and not limit to physically neighbouring countries. Hence, it was suggested during the interview with the Japanese companies that the locations of the production bases before and after are not a concern anymore, especially for the items that are mainly brought by air.

④ Proposals and current efforts for promoting electronics and electrical machinery sector in the future

While currently small in scale, the Sri Lankan electronics and electric sector is a highly prospective industry for foreign investment. In the light of the above potentials, the Survey team's proposals for promoting Sri Lanka's electronics and electrics sector are as follows:

- Fostering supporting industries
- Enhancement of human resource development agencies in the electronics and electrics field
- Diversification of export destinations
- Diversification of export products
- Strengthening Government's support and encourage expansion of existing successful investors

Currently, Sri Lanka's plans¹¹² regarding each of the above proposals items are as arranged in the following chart:

¹¹² Prepared by the Survey team based on interview with SLEMEA and "Electronics and Electrical Sector Baseline Survey 2015".

Table 4-17 Proposal and Correspondence situation of Electronics and Electrics Industry

4: Very Good 3: Good 2: Fair 1: Bad

| Proposal | Correspondence Situation ¹¹³ | Evaluation |
|---|--|------------|
| Fostering supporting industries | Sri Lanka's electronics and electrics industry is only for assembly and parts depend on import from other countries. For this reason, it is expected to nurture domestic supporting industries and increase parts supply that can procure domestically. Especially ISFTA requires added value of 35% or more, so at present it is difficult to utilize FTAs in the electronics and electrical industry. | 1 |
| Enhancement of human resource development agencies in the Electronics and Electrics field, strengthening cooperation with other countries | Compared with other major industries, enhancement of human resource development agencies in the electronics and electrics field has been delayed. German Tech is a representative institution, but there are limitations on the number of students to be accepted and it cannot meet demand. In addition, it is pointed out by several companies that it is not suitable for practical situation. | 2 |
| Diversification of export destinations | Although export destinations have already diversified to some extent, increasing diversification of export destination is considered as risk mitigation. | 2 |
| Diversification of export products | Export products consist of several fields including electric wire, LED / CFL, communication cable, electric panel board, cable harness, power supply protection device, etc., but there are not many high-tech products. | 2 |
| Strengthening Government's support | Current export scale of the electronics and electrical industry is small and it is at the stage of developing, but there is no particular government support for this industry. When developing as an export industry in the future, it is expected that industrial promotion measures such as appropriate government support measures, plans for nurturing the electronics and electrical industry will be formulated. However, SLEMEA's opinion is that there is little correspondence in place due to less recognition of the government for electronics and electrical industry. | 1 |

Source: Prepared by the Survey team

(5) Automotive Parts

① Country comparison

The automotive parts sector in Sri Lanka still remains small with few players, and exports are still far less than major exporting countries. Among the current export items of the automotive parts are wire harnesses, bearings and such. As same with electronics and electric components, the automotive parts manufacturing is also focused on high-tech niche products with small lot production rather than mass production of sheer profit components.

One of the automotive components company in Sri Lanka is manufacturing electric wires, sun visor and brake-pads. These components have a variety of products depending on which segments of the car it will install, and the kind of car determines the production process's complexity as well. For instance a sun-visor set above the driver's sheet has such products variation. Product for lower grade segments should have a minimum function as a movable sun-shade for driver. While for medium segments, a cosmetic mirror is

¹¹³ Corresponding situation based on interview with SLEMEA and "Electronics and Electrical Sector Baseline Survey 2015".

installed and the highest segments equipped with a small lighting system react with mirror cover's movements. To turn lights on for these systems, the wires with a high durability need to be installed in the sun-shade

Recent passenger vehicles have many parts electrically powered such as passenger sheets' adjustment function. These mechanics requires stable electric conductivity and durability based on design engineering for very limited space. Sri Lanka's labour forces are considered to be good at detailed manufacturing of these parts.

However, Sri Lanka faces difficulties in developing labour for auto mobile parts manufacturing. Although there is a vocational training institution called German Tech focusing on automobile, German Tech aimed at maintenance work forces for Colombo's bus fleets. Hence, the school did not offer skills for design manufacturing and mass manufacturing skills. Current course offering in the automotive courses of German Tech are still aiming to train maintenance skills for vehicles but not for components design and/or manufacturing. Basic engineering studies including metallurgical training, welding techniques are provided, however, not provided product design or production. Regarding production process management, robotics, manufacturing design courses were started from two years ago.

Table 4-18 Comparison with other countries in auto parts sector

| | Sri Lanka | Thailand | India | Indonesia | Philippines |
|--|---|---|--|---|---|
| Population (People) | 20 million | 60 million | 1.31.31 billion | 250 million | 60 million |
| Labour wages (manufacturing industry, worker, month) (USD) | 141 | 344 | 239 | 255 | 344 |
| Export value (USD billion) | 5 | 67,000 | 39000 | 16,000 | 13,000 |
| Export value ranking | 78 th | 13 th | 22 nd | 28 th | 30 th |
| Major markets (main export destinations) | | ASEAN (Indonesia, Malaysia), Japan | Europe (Turkey, UK, Germany), USA | Thailand, Philippines, Malaysia, Japan, Saudi Arabia | Malaysia, Singapore, Thailand |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia) • BIMSTEC | <ul style="list-style-type: none"> • CEPT • GSTP • FTAs entered into force by Thailand among the FTAs signed by ASEAN: Japan, Australia, New Zealand, Korea, China • FTA: Peru, Chile • GSP donor country: Australia, Japan, New Zealand, Norway, Switzerland, USA, Russia | <ul style="list-style-type: none"> • FTA: Sri Lanka, ASEAN • PTA: Chile, Afghanistan, Mercosur • CEPA: Japan, Korea • CECA: Singapore, Malaysia • Economic Cooperation Agreement: Finland • Trade Agreement: Africa, Bhutan, Nepal • SAPTA • SAFTA • APTA • SATIS • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Indonesia among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • PTA among D-8 | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • FTA with EFTA |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures according to Article 17 of BOI Act 1978 No.4. Tax exempt from capital goods and tariffs on raw materials is applied for companies exporting 90% or more of the products in manufacturing industry. | <ul style="list-style-type: none"> • The auto parts industry is included in Thailand's investment promotion industry. • For projects that satisfy prescribed approval standards among investment promotion industries, benefits such as exemption | <ul style="list-style-type: none"> • In the auto parts industry, 100% FDI is automatically approved, and licenses and approvals are exempted for manufacturing and importing for auto parts. • The Department of Heavy Industries and Public Enterprises has set up a | <ul style="list-style-type: none"> • After applying to BKPM, investor can receive preferential treatment for income tax on investment in auto parts industry. Up to 30% of the investment amount can be deducted from taxable income for 6 years at 5% per year. | <ul style="list-style-type: none"> • The priority investment field described in the Philippine Investment Priorities Plan (IPP) includes the automobile parts industry. If it meets the prescribed requirements in the automotive parts industry, it becomes a BOI |

| | Sri Lanka | Thailand | India | Indonesia | Philippines |
|-----------------------|---|---|---|--|--|
| | <ul style="list-style-type: none"> Exchange exemption of export oriented industry (including companies exporting 90% or more of manufactured goods in the manufacturing industry) under Article 17 of the BOI Act. | from corporate tax and tariffs are provided. These projects are divided into two types, Group A and B, according to the importance of industry, and receive different level of benefits accordingly. <ul style="list-style-type: none"> For investment in the southern border prefecture, benefits such as exemption of corporate tax and custom duties are provided, based on certain conditions. | USD 200 million automotive parts industry modernization fund to provide loan interest subsidies and subsidies for investing in new factories and machinery. | Furthermore, it can shorten the useful life to 1/2 of usual. | registered company, and can receive benefits such as exemption of corporate tax and other taxes for a certain period of time. <ul style="list-style-type: none"> Manufacturers of manufacturing industries exporting 100% in principle in the export processing zone (Eco Zone) can receive benefits such as exemption of corporate tax for a certain period of time. |
| Value Chain Situation | | Auto parts manufacturer (Tier 1-3), Assembly maker | Auto parts manufacturer (Tier 1-3), Assembly maker | Auto parts manufacturer (Tier 1-3), Assembly maker | Auto parts manufacturer (Tier 1-3), Assembly maker |
| Supplier of Parts | | Mainly from domestic | Domestic, Japan, ASEAN, China | Domestic, Japan, Thailand | Domestic, Japan, Malaysia, Korea, Thailand |
| Comparative Advantage | | The largest supplier accumulation in ASEAN (2180 companies). All kinds of parts can be found evenly in Thailand. | With the growth of the domestic market, auto parts industry also grow steadily. There is also evenly accumulation of all kind of auto parts in India. | Compared with Thailand, the scale is inferior, but variety of accumulated auto parts industry is just as good as Thailand (746 companies). | Although the domestic market is small, Philippines is growing as a parts exporting country. Exports of parts to China and other countries are increasing. However, the area of accumulated parts is biased, and the majority is labour-intensive electric / electronic parts business such as lighting and meters. |

Source: Prepared by the Survey team based on Various Sources

② Sri Lanka position in the value chain

In the value chain for automotive parts, Sri Lanka already has parts assembly, a prerequisite for the global value chain, and has companies with small and medium production in place. However, supporting industries are not yet developed, leaving the sector almost completely reliant upon imported parts. In the future, parts will need to be manufactured domestically in Sri Lanka. Furthermore, the country is expected to build a value chain leveraging its proximity to Chennai in southern India.

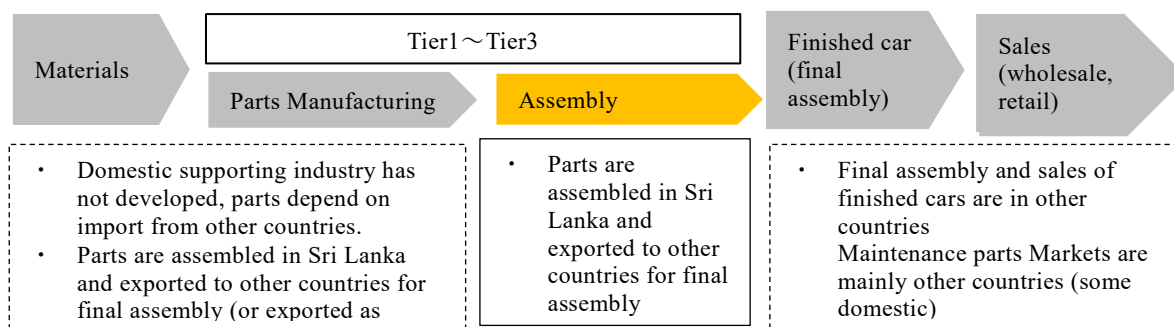


Figure 4-10 Automotive Parts Value Chain and Sri Lanka's Position

Source: Prepared by the Survey team

③ Significance and barriers of entry to foreign-owned companies

Sri Lanka's automotive parts industry has developed through the establishment of foreign factories, and role of FDI in nurturing the auto parts industry in the country was significant. In particular, it has evolved as a parts assembly base serving as part of the global value chain. The major reason of this situation is that although Japanese companies are already carrying out production activities, there were circumstances where other companies were hard to follow, due to difficulty of finding technical talents, and the negative image of the civil war.

Limited labour availability forces, the foreign investors have trained own work-forces and simultaneously conducted business development. However, skill level improvement could not happen over-night and lack of steady supply of skilled labour forces withheld an industry growth.

On the other hand, benefits for investors would be labour forces with a good learning speed, which is what existing investor's value.

The auto parts sectors are considering possibility of entering the southern Indian automotive industries. In fact, Sri Lanka auto parts industry group signed the MOU with the Indian auto parts industry group. These efforts are welcomed, given there have been cases where investors have given up investment due to size of domestic market. Gathering automobile manufacturing related industries already operating in Sri Lanka shall help develop supporting industries, market competitiveness and export volume of high value added products.

④ Proposals and current efforts for promoting automotive parts sector in the future

While currently small in scale, the Sri Lankan auto parts sector seem promising for entry of foreign investments. The structure of automobile parts industry is changing from following-the-giant-manufactures model to selecting-the-production-centre model. In the recent model, companies tend to select production centre suitable for exporting to multiple locations, where their customers are. This change is due to the decrease in business trading with affiliated companies, improving the independence of each parts manufacturer. Also, geographical strength of Sri Lanka, where potential markets could be Africa, Middle East and Europe is attracting more attentions. JETRO's research also suggests growing interests and awareness of potential investors. Based on the above potentials, the survey team's proposals for promoting the Sri Lanka's electronics and electrics sector are as follows:

- Fostering supporting industries
- Enhancement of human resource development agencies in the electronics and electrics field
- Diversification of export destinations
- Diversification of export products

Currently, Sri Lanka's plans¹¹⁴ regarding each of the above proposals items are as arranged in the following chart:

Table 4-19 Proposal and Correspondence situation of Auto Parts Industry

4: Very Good 3: Good 2: Fair 1: Bad

| Proposal | Correspondence Situation ¹¹⁵ | Evaluation |
|---|--|------------|
| Fostering supporting industries | Sri Lanka's auto parts industry is only for assembly and parts depend on import from other countries. For this reason, it is expected to nurture domestic supporting industries and increase parts supply that can be procured domestically. | 1 |
| Enhancement of human resource development agencies in the Electronics and Electrics field, strengthening cooperation with other countries | Compared with other major industries, enhancement of human resource development agencies in the auto parts field has been delayed. German Tech is a representative institution, but there are limitations on the number of students to be accepted and it cannot meet demand. In addition, it is pointed out by several companies that it is not suitable for practical operation. | 2 |
| Diversification of export destinations | Although export destinations have already diversified to some extent ¹¹⁶ , increasing diversification of export destination is considered as a risk mitigation. There is a voice from private sectors that there is a government-led movement to strengthen cooperation with India, but concrete direction is not visible yet. | 2 |
| Diversification of export products | There are wire harnesses etc. as export products, but there are not many high-tech products. | 2 |

Source: Prepared by the Survey team

¹¹⁴ Prepared by the Survey team based on interview with local auto parts manufacturer.

¹¹⁵ Corresponding situation based on interview with local auto parts manufacturer

¹¹⁶ Specifically, Japan, Romania, Russia, Poland, USA, Brazil, India, etc.

(6) ICT

① Country comparison

The Sri Lankan ICT sector has shown rapid growth in the past 7 years, experiencing growth of 20-30% annually. According to SLASSCOM, Sri Lanka is differentiating itself from other countries by providing high value-added services in both the software development and BPO sectors thanks to an infusion of distinguished A/L graduate human resources.¹¹⁷

As with other sectors, the country's small population keeps Sri Lanka distant from handling large-scale development and BPO work. Instead, Sri Lanka is building a presence, particularly in Europe, by developing high-end software and providing analysis and other KPO services, with a focus on the finance and accounting sectors.

¹¹⁷ Interviews at SLASSCOM conducted in April 2017.

Table 4-20 Comparison with other countries in ICT sector

| | Sri Lanka | India | Philippines |
|--|---|--|---|
| Population (People) | 20 million | 1.31 billion | 100 million |
| Labour wages (manufacturing industry, worker, month) (USD) | Programmer : 8,996 BPM Analyst : 4,104 Accountant : 5,977 | Programmer : 10,170 BPM Analyst : 5,451 Accountant : 10,123 | Programmer : 11,371 BPM Analyst : 4,653 Accountant : 8,121 |
| Export value (USD million) | 850 | 98,100 (IT : 77%、BPO : 23%) | 14,200 |
| Major markets (main export destinations) | USA, Europe, Australia | USA & Europe occupies 90% of the whole | North America & Europe occupies 80% of the whole |
| Preferential measures | <ul style="list-style-type: none"> • FTA: India, Pakistan • SAFTA • SAPTA • GSTP • APTA • GSP donor country: EU, USA, Australia, Canada, Japan, Switzerland, Turkey, Norway, New Zealand, CIS, Russia) • BIMSTEC | <ul style="list-style-type: none"> • FTA: Sri Lanka, ASEAN • PTA: Chile, Afghanistan, Mercosur • CEPA: Japan, Korea • CECA: Singapore, Malaysia • Economic Cooperation Agreement: Finland • Trade Agreement: Africa, Bhutan, Nepal • SAPTA • SAFTA • APTA • SATIS • BIMSTEC | <ul style="list-style-type: none"> • CEPT • ATIGA • FTAs entered into force by Vietnam among the FTAs signed by ASEAN: Japan, Australia, New Zealand, India, Korea, China • FTA with EFTA |
| Incentives | <ul style="list-style-type: none"> • Tariff exemption measures according to Article 17 of BOI Act 1978 No.4. Tax exemption from capital goods and raw materials is applied for service companies that receive 70% or more in foreign currency. • Exchange exemption of export oriented industry (including service companies that receive 70% or more in foreign currency) under Article 17 of the BOI Act. | <ul style="list-style-type: none"> • Export Promotion Capital Goods (EPCG) Scheme: When export industries such as software development companies import fixed assets for production activities, custom duties are exempted. • Companies in the Software Technology Park (STP) are subject to the same preferential treatment as 100% export oriented enterprises (EOU), exempted from import tariffs on parts etc., excise tax, service tax, and central sales tax, etc. | The priority investment field described in the Philippine Investment Priorities Plan (IPP) includes IT-BPM industry such as software development. If it meets the prescribed requirements in the IT-BPM industry, it becomes a registered BOI company and can receive benefits such as exemption of corporate tax and other various taxes for a certain period of time. |
| Comparative advantages | Strengths in BPM services in niche fields such as accounting. There is a strength in SME projects, not large scale projects. | Full menu can be provided from software development to BPO. Moreover, it has capability to carry out large-scale projects from the size of the population scale. | Strength in BPO field (call centre). |

Source: Prepared by the Survey team based on Various Sources

② Sri Lanka’s position in the value chain

In contrast to value chain of manufacturing, the position of Sri Lanka’s ICT sector compared to other countries is easier to be understood through analysis of the content created in Sri Lanka. Basically, software development/operation, and outsourcing of work are both part of business processes. Investors pay more attention to the fact of how much value are created by processes outsourced, i.e. carried out in Sri Lanka, with economically cheaper manner, rather than placement within value chain. For the investor, the investment effectiveness is more tangible decision making factor than what processes are to be outsourced and relocate in Sri Lanka,

In fact, at the SLASSCOM interviews, members shared that not many Sri Lankan companies engage low value-addition work such as routine standalone tasks like the Philippines and India do, and Sri Lankan companies have no plans to engage in such work in the future. They said that they are centrally focused on more intellectual, high value-addition work, such as product engineering and KPO, also listing these areas as they want to expand in the future.¹¹⁸

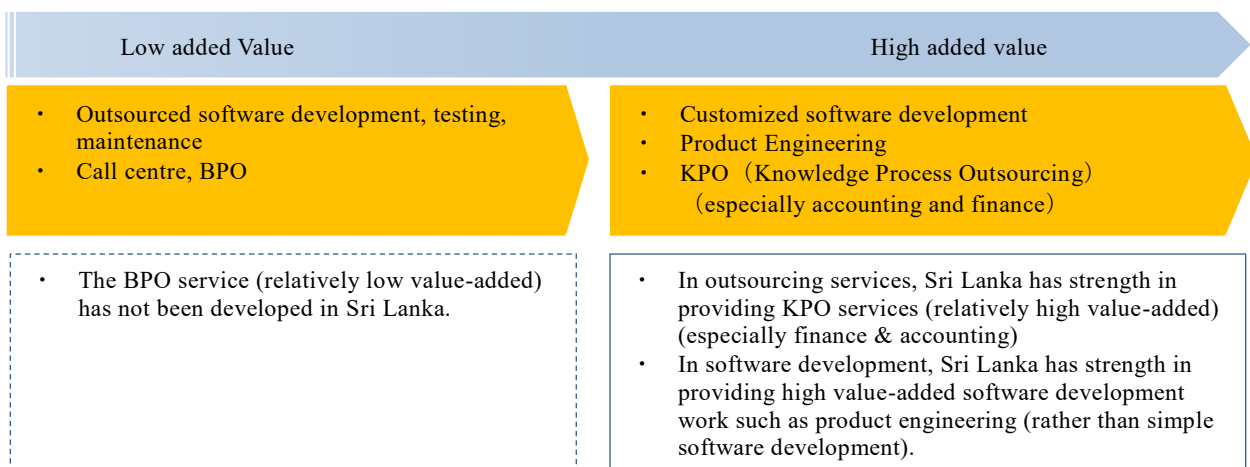


Figure 4-11 Value Chain and Sri Lanka’s Position

Source: Prepared by the Survey team

③ Significance of and barriers to entry of foreign investments

To date, the Sri Lankan IT/BPO sector has quickly expanded thanks to the businesses from the English-speaking regions, including the UK and US. From the SLASSCOM interview, companies hope to continue expanding services to these regions with highly specialized, niche markets. Further, as they have defined Sri Lanka’s strengths as high-end specialists, particularly of finance and accounting, they will not get pulled into price competitions.

Looking forward, given the lower need for capital investment in the IT sector, the key success factor for growth is to maintain quality of human resources. Thus, if industry growth is to continue, human resource development will become increasingly important to provide a steady supply of capabilities. According to SLASSCOM, many industry human resource development organizations are cooperating with programs in

¹¹⁸ Interviews at SLASSCOM conducted in April 2017.

other countries to maintain quality by linking with programs in other countries. It would make sense for such training organizations with foreign ties to expand as the sector continues to grow.

Meanwhile, the benefit of investment in Sri Lanka’s ICT sector is that high value addition services can be served with relatively low labour costs. Particularly in the field of financial accounting, it is possible to conduct not only simple services such as bookkeeping but also more sophisticated financial advisory work, so it is promising as an outsourcing destination in the field of finance accounting.

In comparison with other countries, according to a Sri Lankan local company, India provides good services to large enterprises, but some companies are unsatisfied with the service to SMEs, and thus relocated to Sri Lanka. For this reason, it might be more meaningful for SMEs to consider Sri Lanka as a business partner, in comparison with India.

④ Proposals and current efforts for promoting ICT sector in the future

The ICT sector in Sri Lanka has maintained continuously high levels of growth and is expected to continue its growth. According to the SLASSCOM interviews, the plans are under discussion for promoting the ICT sector based on these issues. The survey team’s proposals for promoting Sri Lanka’s ICT sector are as follows:

- Continuous promotion of high value-addition fields focusing on highly specialized niche areas
- Transition to high value addition businesses within the highly specialized areas
- Maintain and foster educational institutions in order to continue to produce high quality human resources, strengthen ties with other countries
- Promotion of diversification of business partner countries (to increase orders from non-English-speaking countries)
- Providing multilingual services

Sri Lanka’s plans regarding each of the above proposals items are as described in the following chart.

Table 4-21 Proposal and Correspondence situation of ICT Industry

4:Very Good 3:Good 2:Fair 1:Bad

| Proposal | Correspondence Situation ¹¹⁹ | Evaluation |
|---|--|------------|
| Continuous promotion of high value-addition fields focusing on highly specialized niche areas | In the BPM field, there are many business records in areas with high expertise such as accounting and finance. These areas have been focused by Sri Lanka as a country. It is expected that Sri Lankan ICT sector continues to promote high value-addition fields which can take advantage of Sri Lanka’s strengths. | 4 |
| Transition to high value-addition businesses within the highly specialized areas | For example, in the field of financial accounting, though highly specialized sector itself, both high-value-addition operations and low-value operations exist ¹²⁰ . Some companies have plans to shift to more value-addition operations in the future. | 3 |
| Maintain and foster educational institutions | As the continuous supply of advanced human resources is important for the continuous development of the ICT sector, | 3 |

¹¹⁹ Based on interview to SLASSCOM

¹²⁰ As examples, high value addition business: financial advisory, low added value work: book keeping etc.

| Proposal | Correspondence Situation ¹¹⁹ | Evaluation |
|--|--|------------|
| that can continue to produce high quality human resources, strengthen ties with other countries | maintaining and fostering educational institutions including relevant fields is important. Currently, efforts are being made to establish a system that maintains high quality through the introduction of programs in cooperation with other countries. | |
| Promotion of diversification of business partner countries (increase orders from non-English-speaking countries) | Major clients are English-speaking countries (US, UK, Australia). There are transaction records with countries other than English-speaking countries. SLASSCOM is ambitious for diversification of the market, but specific plans cannot be presented. | 2 |
| Providing multilingual services | In the field of BPM, services are mainly provided by English, but some other language correspondence are also served. As part of this, there is also a move to consider providing services by Japanese. | 2 |

Source: Prepared by the Survey team

(7) Logistics

① Comparison with other countries

Sri Lanka is located in a geographically advantageous region, connecting Europe, Asia and the US ports, and functions as an international logistics base. Sri Lanka has grown and recently reviving as a container transshipment hub in South Asia.

Colombo Port, Sri Lanka's largest trade port, is proud of having the largest cargo handling capacity in South Asia. A comparison between Colombo Port and other major neighbouring ports in 2015 is shown in Table 4-22. When focusing on the total amount of cargo handling, cargo amount of the Colombo port is much fewer than that of the major ports; Singapore Port, Jebel Ali Port in UAE, and Port Klang Port in Malaysia. However, when focusing on transshipment cargo volume, a gap gets much smaller between the Colombo Port and the Jebel Ali Port or Port Klang Port. This is because the proportion of transshipment cargo is 75% in Colombo Port in 2015, much higher than that of Jebel Ali Port or Port Klang Port, and it is the same level as Singapore Port.

One of characteristics of Colombo Port is it deals with many transit cargos of India. The amount of Indian cargos transited in the Colombo Port is as much as 1.2 million TEU annually, accounting for 26% of the country's freight cargo. However, the Government of India has decided to reduce the strong dependence on Colombo Port¹²¹. It is therefore the big mission for Sri Lanka to import cargos from countries with geographically advantage such as South Asia, West Asia, East Africa, etc. other than India.

¹²¹ JOC News (2016) "Indian demand Colombo transshipment slowing data shows"

Table 4-22 Comparison of cargo handling volume between Colombo Port and neighbouring ports (2015)

| Items | Colombo | Singapore | Jebel Ali | Port Klang |
|---|-----------------------|------------------------|-----------------------|-----------------------|
| Total Cargo Handling Volume | 5.2 million TEU | 30.9 million TEU | 15.6 million TEU | 11.9 million TEU |
| Transit Cargo Volume (Ratio to total handling volume) | 3.9 million TEU (75%) | 23.3 million TEU (75%) | 7.6 million TEU (49%) | 7.9 million TEU (66%) |
| Transit Indian Cargo Volume (same as above) | 1.2 million TEU (23%) | 0.5 million TEU (16%) | 0.1 million TEU (6%) | 0.2 million TEU (17%) |

Source : Prepared by the Survey team based on various sources including Drewry Maritime Research, Sri Lanka Port Authority, World Shipping Council, and Indian Ministry of Shipping

Meanwhile, BIA, Sri Lanka's largest airport, utilizes its geographical advantage as well as ports, and the volume of cargo handled is steadily increasing. Main export goods are clothing for Europe and the United States, fresh foods for the Middle East and South Asia. As for main import products, electronic parts from East Asia, textiles from South Asia, East Asia and ASEAN. The cargo handling volume in the BIA in 2016 was 248 thousand tons.

A comparison between the BIA and major airports in 2014 is shown in Table 4-23. From this table, we can observe that the volume of cargo handled for domestic use is extremely small, though the international cargo volume is comparable to that of Chennai International Airport. It clearly shows that the domestic market of Sri Lanka is smaller compared to India. Also, looking at the site area, it is clear that the area covered by import cargoes is large, but the export cargo handling area is smaller than the surrounding airports.

Table 4-23 Comparison of cargo handling volume between BIA and surrounding airports (2014)

| Item | Bandaranaike (BIA) | Mumbai | New Delhi | Chennai |
|---------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| International Cargo | 208,673 tons | 482,477 tons | 421,126 tons | 221,678 tons |
| Domestic Cargo | 153 tons | 203,394 tons | 261,468 tons | 78,829 tons |
| Site Area | | | | |
| Export | 11,887 m ² | 14,304 m ² | 34,000 m ² | 16,366 m ² |
| Import | 21,500 m ² | 37,415 m ² | 37,000 m ² | 16,500 m ² |

Source : Prepared by the Survey team based on each airport's website, JETRO, and ACI annual report 2014

② Advantages as an International logistics base and logistics related companies entering Sri Lanka

We discussed the superiority of Sri Lanka as a logistics base through interviews with local companies as follows.

A) Located at the centre of the east-west shipping route / air route

Sri Lanka is located between Asia, the Middle East and Africa, and its geographical location is an advantage as a logistics base. For example, when shipping cargo from Colombo Port to Europe, the East Coast of the United States, Asia, the Middle East and Africa, it is said that the transportation period can be shortened for about 5 days compared to when transported from Singapore Port¹²².

¹²² JETRO (2015), "Survey Report on the Reality of Sri Lankan BOP sector (Logistics Condition)"

B) Deep water with good natural harbour

Ports of Sri Lanka have deep water and thus large vessels can dock. For example, the Indian port is around 10 meters deep, whereas Colombo and Hambantota ports in Sri Lanka have a water depth of around 18 meters. Consequently, cargos for India are once transported to a port in Sri Lanka by a large container ship, and then transhipped to a small ship, and then brought to Mumbai Port or Chennai Port. On the other hand, automotive parts manufactured in India are brought to Sri Lanka Port and are transported from Sri Lanka Port to all over the place by a large container ship. As mentioned earlier, the transit cargo at Colombo Port accounts for a large percentage of Indian transit cargo, and easily access to the huge Indian Market is one of the attractions for Sri Lanka to be a logistics base.

C) Cost competitiveness of cargo transportation is high

The cost competitiveness of cargo transport from Sri Lanka is high. For example, according to the data as of March 2015, the freight transportation fare from Sri Lanka to Singapore is USD 100 per 20 ft. container, besides Singapore to Sri Lanka is USD 1,000. Also, when comparing the cost of sea transport in Colombo and Singapore, Colombo labour cost is USD 1.5 per hour and the warehouse cost per sq. ft. is USD 4.8, while Singapore labour costs are USD 13 per hour and warehouse cost per sq. ft. is USD 13.3. As such, cost competitiveness of Sri Lankan port is high¹²³.

D) System for trade promotion

In order to strengthen the function as a logistics base, the Sri Lankan government actively adopt measures such as tariff exemption measures, re-exports, FTAs, etc. For FTAs, the Government of Sri Lanka has already signed with India, Bangladesh and Singapore, and also plans to sign with countries with large trade volume such as Pakistan and other neighbouring countries, Middle East, Europe etc., according to the Prime Minister's speech in May 2017. In addition, Sri Lanka could regain EU's GSP + tariff benefits on May 19th, 2017. This enables Sri Lanka for tariff-free access to EU for many export items¹²⁴.

Due to the superiority mentioned above as an international logistics base, there has been certain applications for FDI submitted by foreign logistics companies in recent years.

In the interview with several logistics companies, it was mentioned that the reason for entering Sri Lanka was "expecting a synergistic effect with the Indian market." Compared to India, Sri Lanka's regulations are not strict and load handlings are also fast, thus Sri Lanka is an excellent base of cargo transhipment for India with a giant market.

¹²³ JETRO (2015), "Survey Report on the Reality of Sri Lankan BOP sector (Logistics Condition)"

¹²⁴ However, as GSP+ regulates countries that mark as middle-high income, 3 continuous years from obtaining benefits, Sri Lanka, which records GNI USD 3,800 per capita is likely to reach middle-high income countries leaving 4-5years possible GSP+ tariff applicability.

③ Logistics issues in Sri Lanka and significance of foreign companies entry

In order to promote foreign companies to enter more in Sri Lanka logistics sector in the future, it is necessary to refine the attractiveness as a logistics base and further enhance its superiority. Therefore, we listed up challenges that Sri Lanka is facing in international logistics.

A) Capacity shortage of ports

Although the handling volume of port cargo is increasing, delay of handling cargo is occurring because the capacity of Colombo port facility is not enough for the volume of cargo. Besides, private logistics companies have to provide their logistics services such as cargo transshipment and packing outside the port area. Therefore, port expansion is taking place, however not only expanding the space but also facilitating the equipment such as crane and establishing port entrance gate for the improvement of access are necessary to solve the issue.

B) Inefficient port services of SLPA

Value-added logistics services are not provided by SLPA, for instance the space is too small for working with loading and unloading machines, and there are old cargo warehouses with insufficient lighting and small capacity.

C) Capacity shortage of airports

The volume of air cargo handled has also increased and it is necessary to expand existing cargo terminals in BIA. Though the request of this expansion was already conveyed to the Government through logistics related associations, any significant progress has not been seen yet¹²⁵.

D) Inefficient custom clearance procedure by analogue operation

Since the procedure of the customs clearance system is complicated and analogue, it is inefficient operation. Although an electronic customs clearance system named "Asycuda" has been introduced under the concept of single window, it has not progressed well, as it is required to submit on paper in practice. This is due to the fact that the customs regulation is old and there is not enough efforts made to digitize¹²⁶. Besides, import and export customs is located outside the port area, so customs clearance takes for a long time.

Several logistics companies as well as the Shippers' Council, an industry group representing logistics companies and shippers, pointed out issues such as port facility's capacity shortage, insufficient connectivity of ports and airports and delay of rationalization of custom clearance. In particular, transshipment operations in the port of Colombo is not efficient enough and does not correspond to the concept of multi-country consolidation according to the study. The concern regarding ISFTA's future

¹²⁵ The fact that an expansion of freight terminal is under planning was confirmed through the logistics study.

¹²⁶ According to "Data Collection survey on Logistics Sector in Sri Lanka," the customs Regulation stipulates that "customs officials can request copies of original documents and necessary copies."

detailed operation rules were raised. Logistics businesses concerned that procedures would become complicated because there are many products already decided as subject to negative lists, and items of the negative list can vary depending on state in India. Given the fact that Sri Lanka handles large amounts of freight shipments to India, increasing complexity of handling procedures would adversely impact to the trade relationship between two countries.

Sri Lanka's strength is the function as an international logistics base. In order to promote export industry further, domestic logistics is also required to be strengthened. The challenges of domestic logistics was presented through the survey are listed below.

A) Traffic congestion in urban areas

Delays in cargo transport are caused by traffic congestion in urban areas such as Colombo and Kandy. For example, logistics transportation from Colombo to Kandy took two hours in the past, which now takes 4 hours. Local companies are examining move cargos during night time to avoid traffic congestion during day.

B) Undeveloped freight transport network from inland area

In many cases, factories are established in inexpensive inland areas where transport networks to the coastal areas are not developed well. Many companies strongly expect the central highway project in place promptly. It was also pointed out that existing railway systems are not fully utilized for freight transportation.

C) Laws and regulations concerning logistics services not yet established.

Under the current law, acts which may encourage poor quality service such as insufficient maintenance vehicles for domestic cargo transport and warehouses with insufficient fire prevention measures are not prohibited. As for the warehouse which is an important element of logistics in particular, since the warehousing business act is not introduced, the enterprises who carry out appropriate warehouse management are not protected. Meanwhile, irresponsible enterprises with low quality services are not excluded.

Logistics companies and companies which have factories in inland areas pointed out that congestion of urban area roads and inadequate maintenance of freight transport networks from inland areas are problems. In addition, the lack of legislation such as warehousing business act concerning the quality assurance of logistics services is also a problem in logistics services both in domestic and overseas context.

Currently, 108 companies are affiliated with SLFFA¹²⁷, which is a leading logistics industry association in Sri Lanka. It is expected that more and more foreign logistics companies enter to the Sri Lankan logistics

¹²⁷ Abbreviation for Sri Lanka Logistics & Freight Forwarders Association. Since its establishment in 1981, as an industry organization representing the logistics industry in Sri Lanka, it provides various suggestions and trainings for member companies to help Sri Lanka's logistics development.

market and competition to be accelerated, and thus logistics services to be improved.

④ Proposals for the future promotion of the logistics industry and current correspondence situation

Based on the characteristics and challenges as the hub shown so far, the survey team's proposals for promoting the logistics industry are as follows:

- Expansion of port and logistics facilities at Colombo Port, Dispersion of port functions and functional enhancement of Trincomalee port
- Improvement of efficiency of port operations by port authority SLPA
- Expansion of BIA Cargo Terminal
- Introduction of IT and rationalization of customs clearance procedures
- Widening road, Improving connection of each modality such as bus and railway
- Construction of expressway
- Revising laws and regulations to tighten license acquisition of logistics companies and legislation of warehousing business act

Sri Lanka's plans regarding each of the above proposals items are as described in the following chart.¹²⁸

Table 4-24 Proposal and Correspondence situation of Logistics Industry

4: Very Good 3: Good 2: Fair 1: Bad

| Proposal | Correspondence Situation | Evaluation |
|--|---|------------|
| Expansion of port and logistics facilities at Colombo Port, Functional enhancement of Trincomalee port | <ul style="list-style-type: none"> • Colombo port development plan (start / expand ECT operation, expand WCT, etc.), formulate Mega polis plan. • Examination of functional advancement of Trincomalee Port. (Expansion of quay wall, ensuring connectivity of land transport, improvement of navigation route signs, etc.) | 3 |
| Improvement of efficiency of port operations by SLPA | <ul style="list-style-type: none"> • Implementing the improvement of efficiency of port operations such as development of new logistics areas by SLPA (There is prospect of requiring a great deal of time and expense) | 2 |
| Expansion of BIA Cargo Terminal | <ul style="list-style-type: none"> • Although BIA cargo terminal expansion is proposed by related organizations, there is no progress yet. | 2 |
| Introduction of IT and rationalization of customs clearance procedures | <ul style="list-style-type: none"> • Although introduced electronic customs clearance system (Asycuda), it was not accompanied by actual implementations, and the old customs regulations are being revised. | 3 |
| Widening road, Improving connection of each modality such as bus and railway | <ul style="list-style-type: none"> • Plan to establish elevated roads and bridges to improve connectivity, with the goal of improving each modality connection in "Public Investment Program 2017-2020" | 2 |
| Construction of expressway ¹²⁹ | <ul style="list-style-type: none"> • Planning to construct Colombo – Kandy highway under preparation | 3 |
| Revising laws and regulations to tighten license acquisition and | <ul style="list-style-type: none"> • Although legislation to grant licenses to logistics companies is in place, the warehousing business act has not been | 2 |

¹²⁸ Prepared by the Survey Team based on "Data Collection survey on Logistics Sector in Sri Lanka" and interviews

¹²⁹ In addition to construction of highways, the necessity of utilizing railway container transportation was pointed out in the interview. Based on these needs, although SLR purchases new rolling stocks, the utilization of railways for freight transportation should be carefully examined because the viability is generally low unless long-distance transportation.

| Proposal | Correspondence Situation | Evaluation |
|---|--|------------|
| legislation of warehousing business act | maintained and companies that provide low-quality services cannot be excluded. | |

Source : Prepared by the Survey team based on "Data Collection survey on Logistics Sector in Sri Lanka" and interviews to the logistics companies and industry organizations

(8) Tourism

① Significance of and barriers to entry of foreign investments

The Sri Lanka's tourism industry grows rapidly after the peace concluded, with a rich tourism attractions such as World Heritage sites. Until now, as a relatively inexpensive sightseeing spot, Sri Lanka is successfully attracting customers though lower expenses per tourist. Sri Lanka aims to increase per capita expenses per tourist. Investment by foreign enterprises in accommodation is expected to increase further, as it is the largest foreign currency acquisition sector among tourism income.

For foreign investors, Sri Lanka's abundant tourism resources are attractive and the number of inbound tourists' growth are envisaged. Hence, investment can also be fortified to fulfil tourist's expectations. In addition, for tourism related investment, one-stop unit specialized for tourism sector has been established by The Sri Lanka Tourism Development Authority (SLTDA). This one stop unit provides services to investors, and also provides related services for investment related procedures. As such, system for investors in tourism sectors are under development¹³⁰.

② Proposals and current efforts for promoting tourism sector in the future

The tourism industry in Sri Lanka is a major foreign currency acquisition industry and is expected to grow steadily in the future. The proposals for further promotion of the Sri Lankan tourism industry are as follows.

- Proactive development of profitable sectors among tourism industry
- Human resources development
- Diversification of tourists

Sri Lanka's plans regarding each of the above proposals items are as described in the following chart.¹³¹

Table 4-25 Proposal and Correspondence situation of tourism Industry

4:Very Good 3:Good 2:Fair 1:Bad

| Proposal | Correspondence Situation ¹³² | Evaluation |
|--|---|------------|
| Proactive development of profitable sectors among tourism industry | Raising tourist unit price is set as a goal, and the list of nurturing areas with high profitability are also prepared. As such, strategies for improving tourism income have already been planned by the Government. | 3 |

¹³⁰ SLTDA website. (June, 2017)

¹³¹ SLTDA website. (June, 2017)

¹³² Based on SLTDA website. (June 2017)

| Proposal | Correspondence Situation ¹³² | Evaluation |
|-----------------------------|---|------------|
| Human resources development | Since it is a rapidly growing industry, it is necessary to continuously develop human resources for continuous expansion in the future. | 3 |

Source: Prepared by the Survey team

4.2.3 Business environment analysis of each promising industry (industries other than current export industries)

In this section, observations are given to the industries which are currently less active in manufacturing or export, but considered as the promising.

(1) Pharmaceutical

The history of pharmaceutical industry in Sri Lanka as a manufacturing industry is brief, medicines, other than local Ayurveda prescription drugs, circulating in the country depend mainly on imports. Specifically, among medicines consumed in the domestic market, domestic production covers about 10%, and the remaining 90% depend on imports. Of the import destinations, 60% are from India, 10% are from China, and the remaining 20% are from other countries. Sri Lanka's pharmaceutical sector is currently producing existing generic medicines, and is not yet in depth of conducting R&D for new prescription of drugs. Sri Lanka utilize Ayurveda prescriptions to with naturally derived ingredients mixed with known Western prescribe drugs.

Pharmaceutical industry of Sri Lanka is still small in scale, but it is in the stage of growing, there is also a strong desire for attracting FDI with new products and technology. The Government actively promotes pharmaceutical industry. For instance, the Sri Lankan government introduced a buy-back scheme¹³³ in 2014, and since that time the total sales of domestic pharmaceutical companies in Sri Lanka nearly doubled in three years.

According to the Sri Lanka's Pharmaceutical Industry Association (Sri Lanka Pharmaceutical Manufacturers' Association), it is expected that pharmaceuticals for domestic consumption will be the centrepiece for a time being. However, the industry expands the market outside of the country, initially target Maldives for medium term, followed by Southeast Asian and African markets for longer and strategic targets.

Regarding foreign investors in pharmaceutical sector, Glaxo Smith Kline (GSK) built the first foreign factory in pharmaceutical sector in Sri Lanka in 2012, and announced to make an additional investment of USD 11.12 million in 2014 for expansion. In addition to such foreign enterprises' investment, there are

¹³³ In 2014, by the initiative of Minister of Health, a system of 17 categories of domestic drugs were supplied to public hospitals is established. In 2015, it was inherited as a "Guaranteed Buy Back Agreement in a Public and Private Partnership" scheme and 11 private pharmaceutical companies agreed to supply 56 drugs to the public hospital for 5 years. According to the local news report in February 2017, the buy-back scheme was extended to 10 years and 22 companies were registered (February 14, 2017).

more than 20 local pharmaceutical companies in Sri Lanka, and future growth of the pharmaceutical industry is highly expected.

In this way, the pharmaceutical industry in Sri Lanka is growing, and it is considered as promising to target the manufacture of products for the domestic market in the beginning, and then target the manufacture of products for overseas market after that.

(2) Medical Device/ Equipment

75% of medical device/ equipment in Sri Lanka relies on imports from other countries and the remaining 25% in domestic production. Most Sri Lankan medical equipment companies are import dealers, several manufacturers are in the process of being nurtured. The willingness for attracting FDI with new products and technology is as large as the pharmaceutical industry, and the Government also actively promoting the medical equipment industry. The current main products are relatively simple equipment such as medical rubber gloves, and complicated medical device manufacturing is dependent on import.

Although the World Bank lists medical devices as a promising industry, it was mentioned that medical devices refer to items such as medical rubber gloves, and complicated medical device manufacturing is not intended to be included¹³⁴.

Thus, similar to the pharmaceutical industry, Sri Lankan medical equipment industry is also growing, and it is considered as promising to target the manufacture of products for the domestic market in the beginning, and then target the manufacture of products for overseas market after that. Especially rubber glove is a major product among the rubber processing products, and it is considered efficient to expand production of medical devices from the products with existing strengths.

(3) Solar panel

Solar panel has not been produced so far in Sri Lanka and it is in the stage of development. A raw material for solar panel, silica, is available in Sri Lanka, and some study recommended solar panel as promising manufacturing industry in Sri Lanka.

Following recommendation of the study, BOI implement the promotional activities of solar panel which is facing difficulties. The value chain of solar panels, supposed to be includes parts manufacturing and assembly processes, which are already developed in China and India and hard to induce investment into Sri Lanka. BOI considers it is challenging. Particularly, Chinese solar panels are globally marketed and many other inexpensive products are on the market as well, and thus it is a difficult market for new entrants. Therefore, survey team observes that it is difficult to newly develop solar panels as a potential export industry which can compete in the world market.

4.2.4 Consideration on Industries to be Prioritized

Among the 11 promising industries analysed in the preceding sections, prioritized industries need to be selected for development. The survey team would like to propose to apply two criterion for determining

¹³⁴ Interview to the World Bank (May 2017).

priority: (1) existence of successful cases in Sri Lanka to demonstrate to future investment and (2) potential for fostering supporting industries to generate more job opportunities. As a result, priority shall be given to auto parts and electronics & electronics. In Sri Lanka, both industries are still under development, hence, deployment of foreign companies will give positive impacts to the industries’ development by bringing relevant technologies and access to the global value chain.

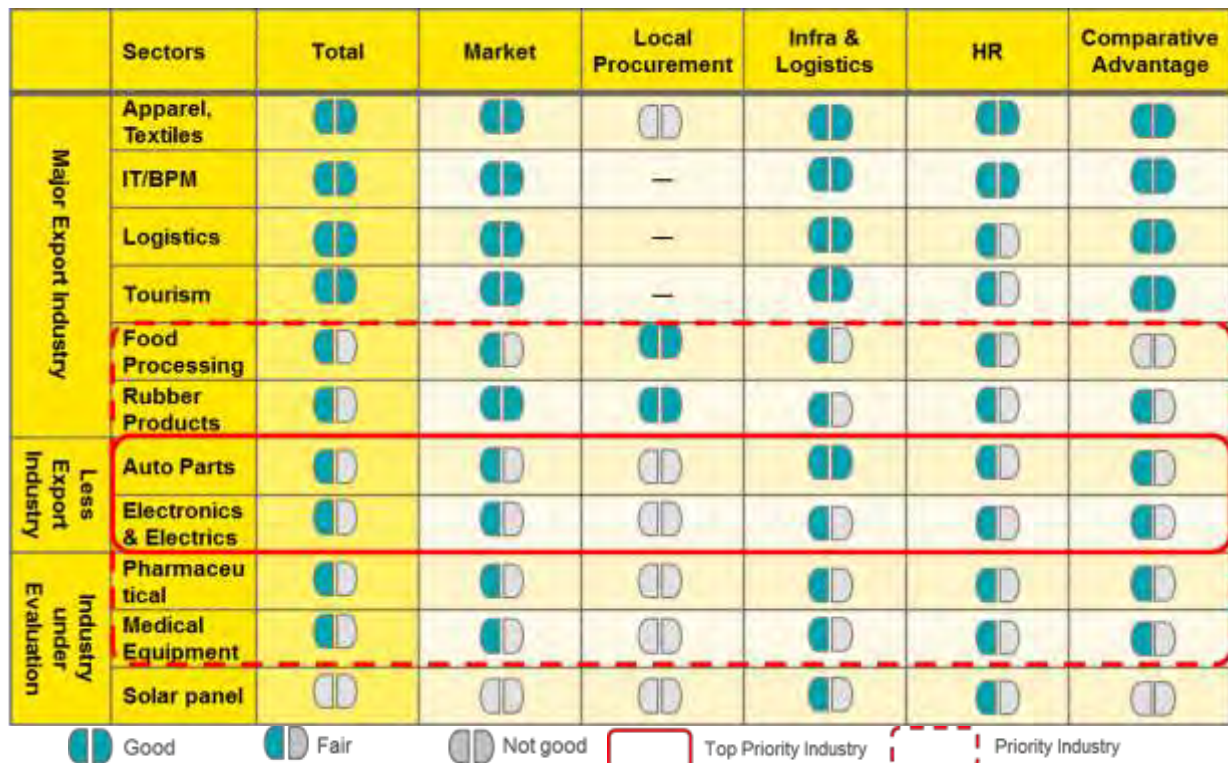


Figure 4-12 Extraction of priority industries of Sri Lanka

Source: Prepared by the Survey team

As shown in the Figure 4-12 above, overall evaluation of six major export industries is high. Out of these six industries, Textiles and apparel, IT/BPM, logistics, and tourism have already been successfully developed in Sri Lanka. For these four industries, we can expect autonomous development as Sri Lankan government and industrial associations have a clear vision for each industry development.

On the other hand, regarding food processing and rubber industry, there are many points that need to be improved compared to the other four, and overall evaluation has been lowered. However, the needs for technical support from foreign investors are intensive, because there is a potential of improvements by mechanical efficiency improvements and/or human resources development in resource & raw material processing.

With regard to automotive parts and electronics and electrical sectors, which are relatively small export volume at the moment in Sri Lanka, development potential is high. The reason of lower scores in the above figure is due to difficulty in local procurement and lack of skilled human resources to broaden industry

basis. Since Sri Lanka is highly evaluated for the learning speed of human resources, there is a potential for growth with appropriate human resource development. In addition, companies belonging to automotive parts, electronics and electrical sectors have possibilities to develop as clusters, and thus the accumulation of companies would accelerate, possibly along with the development of industrial parks.

Finally, among the industries currently not exporting, pharmaceutical and medical devices sectors are expected to grow in the future, as the domestic market is expanding. On the other hand, with respect to solar panel manufacturing, as the worldwide competitive environment intensifies, it is not necessarily advisable to newly start an industry.

With above circumstances, the auto parts industry and the electronics and electrical industry are considered to be the top priority industries.

Taking into account all factors discussed above, auto parts and electronics & electrics are the most prioritized industries. Food processing and high value rubber processing are also industries with potential of growing, however, these two industries are inferior to auto parts and electronics & electronics in terms of the supporting industries scale of job creation. Pharmaceutical and medical devices are focusing on domestic market at the moment, and industry itself is at the embryonic stage.

4.3 Analysis of investment determinants and inhibiting factors based on the Survey of willingness to invest of foreign companies

The survey team conducted “Survey of willingness to invest of foreign companies” based on the interviews to foreign companies by mainly focusing on Japanese companies. From February to May 2017, the survey was conducted by interviewing 18 Japanese companies, 17 local companies and industry groups, totalling 35 companies and organizations.

As a result of interviews, determinants and inhibiting factors of investment are as summarized in the table below.

Table 4-26 Analysis of factors of investment decision and barriers to Sri Lanka¹³⁵

| Issue | Item | Evaluation (*) | Overview |
|----------------------|--|----------------|--|
| Market | Product demand in local market | 1 | As the population of Sri Lanka is small, the domestic market is small, and foreign companies doing business in Sri Lanka are rarely aiming at the domestic market, mainly focusing on manufacturing products for export. |
| | Product demand in neighbouring countries | 3 | As a part of the global value chain, many foreign companies export not only to neighbouring countries but also to Europe, the United States and Middle East Africa. |
| Business environment | Stable political and social environment | 2 | The image of the country that there was the civil war eight years ago still remained. |
| | Ease of Doing Business | 3 | Ease of Doing Business is relatively high in Sri Lanka, because foreign companies make profits in general and there are few companies withdrawing. |
| Infrastructure | Infrastructure cost | 2 | Infrastructure cost such as land fee, logistics and transport cost etc. are relatively low and considered superior, but it is disadvantageous in terms of high electricity bill. |

¹³⁵ Prepared by the Survey Team based on the Survey of Willingness to Invest of Foreign Companies.

| Issue | Item | Evaluation (*) | Overview |
|------------------------------------|---|----------------|---|
| | Infrastructure quality and reliability | 3 | The quality and reliability of the infrastructure are generally high compared to those in neighbouring Southwest Asian countries such as India, and they are close to ASEAN's. |
| | Transport and logistic system | 3 | Access from Colombo Port is well both to east and west and it is advantageous in international logistic system. On the other hand, domestic transport and logistic network is relatively weak. |
| | Land availability | 2 | Since there is almost no vacancy in the existing industrial park, it is difficult to enter the industrial park. |
| Human Resource | Availability of skilled workforce | 2 | Many companies point out that it is becoming difficult to secure skilled engineers around Colombo. |
| | Availability of managerial staffs | 1 | Many companies point out that it is difficult to secure managerial staffs since there are few universities in Sri Lanka (graduates are mandatory as hiring standard). |
| | Local labour skills | 4 | Human resources are at a high standard compared with ASEAN countries (Some point out they are superior to even Thailand) and attractive to many companies considering relatively low labour cost and many production processes for high-end products. This is often the deciding factor for foreign companies of entering into Sri Lanka. |
| | Local labour cost | 3 | Many companies point out that Sri Lanka do not belong to the country group of lowest labour cost, however it is relatively low considering the quality of labour. |
| Legal system | Legislative and administrative environment ¹³⁶ | 1 | Besides to the fact that there are insufficient legislative improvements, many companies feel difficulties that there is much room for arbitrary operation by person in charge. In addition, it was pointed out that it is hard to foresee because of many policy changes and is not suitable for large scale investment. Many companies point out that such instability of the legal system is the biggest impediment to investment. |
| | National Taxes | 2 | Many companies feel difficulties in frequent changes in tax system, particularly those that are disadvantageous to investors. In addition, additional taxation due to sudden changes in the interpretation of tax laws and cumbersome interaction with customs were pointed out as negative factors. |
| | Foreign Direct Investment Policy | 2 | Tax Holiday has been abolished and there is little investment incentive. |
| Value Chain | Access to raw materials | 2 | Depending on the type of industry (Industries in which local production is possible, such as food and rubber industries, have access to raw materials, while supporting industries such as electronics and electric machinery are underdeveloped.) |
| | Access to local suppliers | 2 | Same as above |
| | Access to business partners | 2 | As there are not many companies entering into Sri Lanka, it is difficult to have business partners in Sri Lanka (although there are many business partners in major export industries such as the sewing industry). On the other hand, some companies feel an advantage that there is little competition based on the small number of enterprises entering into. |
| Expatriate dispatching environment | Living and working environment | 3 | There were several opinions that the living and working environment in Sri Lanka is good for Japanese expatriates compared with the one in neighbouring countries such as India. |

¹³⁶ Details of the issues on legal system are written in 3.5.

| Issue | Item | Evaluation (*) | Overview |
|--------|--|----------------|--|
| | Crime and Safety | 3 | Many companies point out that Sri Lanka is safe Buddhist country and it is easy to live in. |
| Others | Ease of appealing to a management of headquarter | 2 | As Sri Lanka is an average country with neither plus nor minus, it tends to be difficult to appeal to the management of the company and obtain its approval to invest in Sri Lanka. There were several opinions that private holding companies are easier to make the decision to invest than large companies. |

*Legend of evaluation: 4-Very attractive, 3-Fairly attractive, 2-Little attractive, 1-Not attractive

Source: Survey of willingness to invest of foreign companies

The results of the above survey are rearranged according to evaluation points, as shown in the table below.

Table 4-27 Analysis of Investment Decision and Inhibiting Factors in Sri Lanka

| Score | 4 Very Attractive | 3 Attractive | 2 Fair | 1 Not Attractive |
|-------|--|---|--|---|
| Items | <ul style="list-style-type: none"> ■ High basic learning skills | <ul style="list-style-type: none"> ■ Product demand in neighboring countries ■ Ease of doing business ■ Infrastructure equality and reliability ■ Transport and logistics ■ Local labour cost ■ Crime rate and safety ■ Living and working environment | <ul style="list-style-type: none"> ■ Stable political and social environment ■ Infrastructure cost ■ Availability of skilled workforce ■ National taxes ■ Foreign direct investment policy ■ Access to raw materials ■ Access to local suppliers ■ Access to business partners ■ Land availability ■ Ease of appealing to a management in the HQ | <ul style="list-style-type: none"> ■ Product demand in local market ■ Availability of managerial staffs ■ Legislative and administrative environment |

Source: Survey of willingness to invest of foreign companies

Based on the results of the survey of willingness to invest of foreign companies, the important points for improvement of the business environment are as follows: ① Legal system and structure improvement over FDI, ② Strengthening supply of skilled labour force which is a key attractiveness of Sri Lanka, ③ Maximized utilization of existing EPZs and development of a new EPZ.

Especially regarding human resources, although basic learning ability is highly valued from enterprises, there are difficulties in securing numbers of human resources, and thus human resource development is essential for the companies already operating in Sri Lanka and for prospective investors' confidence.

4.4 Business Environment Perceived by companies expanding their business in Sri Lanka

In this section, based on the survey on willingness to invest by foreign companies shown in the previous section, analysis will be made on Sri Lankan business environment from investors' point of view. Observations will be focused on foreign companies already operating in Sri Lanka, and those who did not enter Sri Lanka.

4.4.1 Business environment perceived by companies based in Sri Lanka

As a result of interviews with 20 foreign companies operating in Sri Lanka and industry organizations, typical perceptions on the local business environment, are summarized as follows.

(1) Market access

- Strategically important location accessible to markets extending to Europe, Middle East, and Asia
- Global value chains can be developed (on the condition that their mode of transport is airfreight. The promising target is products in a light weight products range, such as electronics and electrics)
- A trans-shipment hub for exporting processed goods (For instance, Sri Lanka has more advantage in supplying parts to southern India, than transporting items within India)
- Access to the market in India (Note, however, that there are difficulties in customs clearance in Indian ports, making shipping transport undesirable. Alternatively, a successful case has been an airfreight-based value chain.)

(2) Environment for product manufacturing

- High value-added products requiring advanced skills can be manufactured
- Location suitable for small-batch production (with many variants) of high-end products, rather than mass-producing low-cost products
- Low local procurement rate, and supporting industries underdeveloped
- Although infrastructure (power, water, etc.) necessary for manufacturing is generally well developed, electricity tariffs are high
- Conglomerates are being formed in the country. A cluster of local companies is growing, could become potential partners to foreign companies

(3) Distribution system

- Good accessibility to Port of Colombo
- Insufficient development of transport network from inland to ports

(4) Human resources

- Availability of labour force with high basic learning skills, albeit relatively low cost
- High literacy, and plentiful English-speaking labour force
- Relatively low labour turnover rate
- Disparities in labour availability by sectors and regions
- Difficulty in implementing large-scale projects requiring thousands of employees, due to shortage of workers (Sri Lanka is thus suitable for hosting small-scale and medium-scale projects)

(5) Legal system

- Sudden changes in legal systems made without prior notice (unfavourable for investors)
- Frequent regulatory revisions (particularly to tax systems) causing unforeseeable circumstances, unsuitable for large-scale investment (Therefore recommendable to launch a business in the niche market)
- Lack of transparency in legal practices (Understanding of laws/ regulations are left to individual operators, in some cases requests not properly written in laws are made)

- Time-consuming customs clearance, also lacking transparency

(6) Others

- Living environment more comfortable than in neighbouring countries
- Relatively few companies withdrawn or failed their business

Business environment of Sri Lanka is highly evaluated, particularly human resources. The legal system is the more difficult to deal with, therefore foreign companies are hoping for improvement. Backed by its logistical advantages, Sri Lanka is highly evaluated as an export base for countries in Europe, the U.S and/or other emerging markets.

4.4.2 Evaluation on Sri Lanka by companies Diverted Their Investment

Information on 10 companies which gave up their investment to Sri Lanka were retrieved in interviews. Following four factors were mainly pointed out¹³⁷.

(1) Small market size

- In comparison with investment costs required to construct a manufacturing plant, the market is too small in Sri Lanka. The company decided to invest in Indonesia (automobile).
- The domestic market is too small to manufacture and sell products (light apparatus).

(2) Substantially high import duties

- Plan to construct a knock-down production factory in Sri Lanka was given up, due to high import duties (motorcycle).

(3) Minimum investment amount when applying for BOI Company is excessive

- Although the company considered applying to a BOI Article 17 Company, their proposal could not meet the minimum investment amount (USD 1 million), therefore negotiated for Article 16 Company (minimum investment amount of USD 250 thousand). But eventually as the company was told that the project scale was less than the minimum investment amount, and was not permitted as Article 16 Company as well. The company gave up its investment to Sri Lanka and advanced to Cambodia (auto parts).

(4) Influence of change in government administration

- A construction project planned in southern Sri Lanka was terminated, due to the frequent revisions of licenses and permits by change in government administration (automobile).

¹³⁷ We extracted only the subjects of Sri Lanka side, and excluded the withdrawal due to the circumstances of the company side.

- A casino project was planned in Colombo, and potential site had been decided. However due to changes in government administration, approved permits were cancelled, and the construction work, and eventually the project, were both suspended (real estate).

Although the survey team could not obtain much information on enterprises withdrawing from Sri Lanka, we were able to confirm several issues on the legal system, the influence of administration change, and small market size.

4.4.3 Disparity in perceptions of the business environment

In comparison with other countries, there seems a distinct perception gap on the local business environment of Sri Lanka between the foreign companies already based in Sri Lanka, and others.

More specifically, the following attributes are subjects to the above-mentioned gap, which companies do not understand as Sri Lanka's generic advantages.

(1) Market

Companies often drop Sri Lanka from their business destinations, seeing the limited domestic demand and small population size. In fact, Sri Lanka offers better accesses to markets in neighbouring countries in Southwest Asia, Europe, Middle East, Africa, and Asia, which should be promoted.

(2) Human resources and skills

Existing companies evaluate level of basic education and learning speed of workers, and the ease to manage business in English. Furthermore, the relatively low-cost of labour force as to their skills has also earned a good reputation. Several companies commented the competencies of the work force is almost equal or better than Thailand in some cases. Nonetheless, Japanese companies barely share such perception. A recognition gap then arises with a stereotypic view that Sri Lanka entails relatively high labour cost compared with Bangladesh and other neighbouring countries. In practice, the labour cost in Sri Lanka should be properly understood in the context that the country could provide a manufacturing base for high-end products, unlike the countries producing low-end products.

Sri Lanka is suitable for small-batch production of high-end products, rather than for mass production of low-end products. This matches up with the need for small-batch, high variant production often favoured by Japanese market¹³⁸. For example, companies could relocate parts of their production line from Thailand, Malaysia, etc. to Sri Lanka, in line with the production decentralization movement. In other words, rather than competing with nearby exporting countries, positioning as a complementary role will be effective for Sri Lanka.

¹³⁸ In general, companies based in mass-producing countries are less willing to organize a production line for small-batch product with many variants.

(3) Infrastructure and logistics

As seen with the reasonably stable power supply, infrastructure in Sri Lanka is in a good condition compared to its neighbouring countries. Furthermore, serving as a hub port for those countries, the Port of Colombo, the largest port in South Asia, transits 70 percent of its cargo to India including trans-shipments. In fact, compared with Bangladesh and Pakistan, Sri Lanka is located on a container shipping route of many countries, which is certainly an advantage.

These well-developed infrastructures of Sri Lanka seem under evaluated, so investors should pay more attention to such features.

As mentioned above, there is a distinct perception gap of the market, labour force, and infrastructure/distribution system in Sri Lanka between foreign companies based in the country, and those not yet operating. Reasons behind such gap could be that investors regard Sri Lanka as a part of India or Southwest Asia, and therefore anticipate similar business environments. In other words, because information on Sri Lanka is insufficient, investors supposedly conceive that the country remains as a low-cost products producer, with unskilled labour force and underdeveloped infrastructure. These negative perceptions may have arisen from the history of civil war in the past. Additionally, given the small population size, investors supposedly tend to exclude Sri Lanka in the first place from exploring the potential market, without fully analysing business feasibility.

On the other hand, evaluations from existing foreign companies are high. By properly understanding the varying perceptions, Sri Lanka could help investors broaden their choice of business destination for small-batch, niche products manufacturing plants¹³⁹.

¹³⁹ Note, however, that this does not eliminate possibilities of business expansion by large-sized companies. They may branch out by transferring a non-mass, small-batch manufacturing line of niche products or advancing automation for machine-based industries.

5 Action Plan for Improving of Investment Climate in Sri Lanka

5.1 Structure of Action Plan

This chapter describes the actions to be taken by Sri Lankan government to improve investment climate and business environment of the country. Actions that can be taken without significant regulatory changes or organizational reforms are labelled as “Short” term actions and proposed to be achieved by the end of 2018. Actions that need to involve multiple ministries and organizations, and thus take more time, are labelled as “Medium” term actions by the end of 2022. Goals are set for each category without defining timeframes. The actions are related to each other and following sections elaborate their contents and relationship.

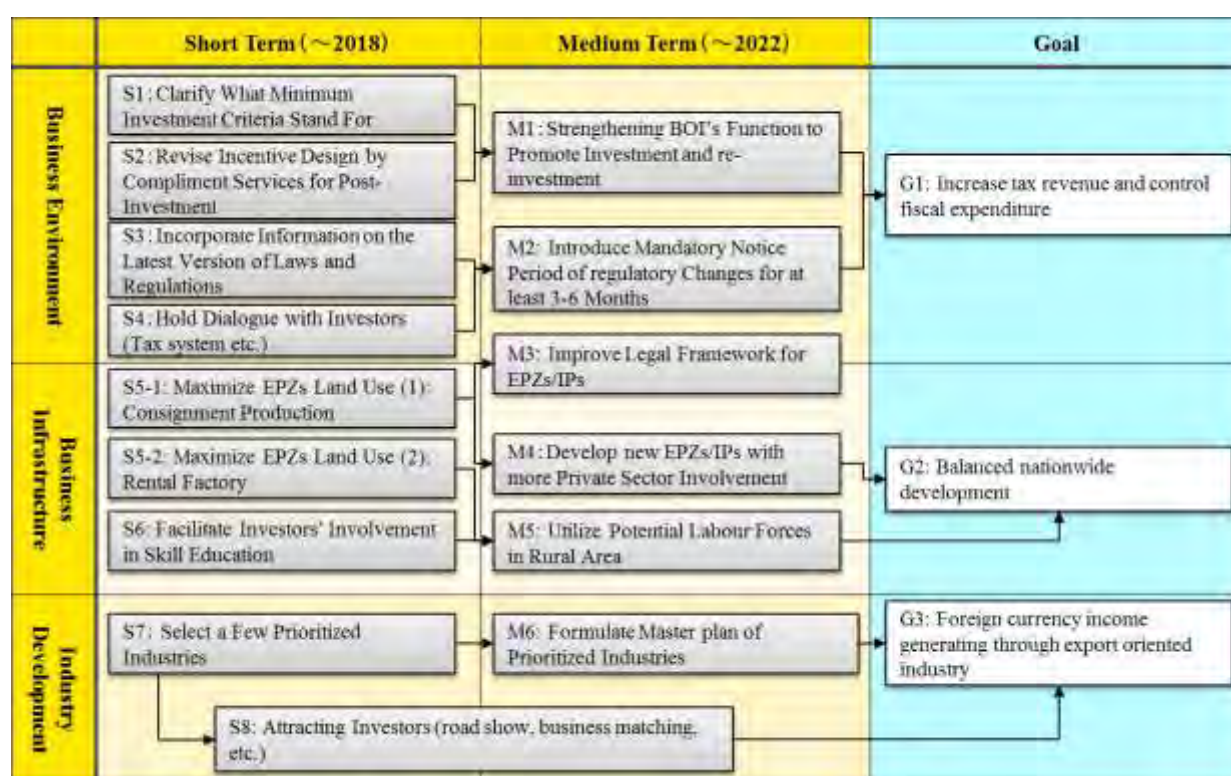


Figure 5-1 Draft Action Plan

Source: Survey team

5.1.1 Background of Action Plan Items

In the processes of development of this action plan, three key categories were set to sort actions, which are “Business Environment”, “Business Infrastructure” and “Industry Development”.

“Business Environment” covers regulatory framework and tax systems impacting investment decisions and predictability of private sector. “Business Infrastructure” includes the conditions of land for investment, and human resources for operations. Lastly, the industry promotion and development policy has to be defined to build export industry throughout short term and medium term time frame with a comprehensive industry promotion policies.

Each action plans are marked with “S” for Short term and “M” for medium term for the reference purposes. However, completion of short term action plan is not a pre-requisite to trigger medium term actions.

5.2 Specific actions to be taken in each category

5.2.1 Business Environment

Transparent and consistent regulatory framework is an important factor to create favourable business climate for investors.

Sri Lanka’s legal environment involves issues such as lack of predictability and transparency due to frequent regulation changes followed by insufficient notice period and scattered information. Specific actions to be implemented are suggested below.

(1) Short Term

S1: Clarify What Minimum Investment Criteria Stand For

Minimum investment criteria were originally introduced to assess eligibility for tax incentives based on BOI Act. Thus, the minimum investment criteria should have been repealed when the tax incentive based on BOI Act became invalid in 2011. However, the criteria have been referred as eligibility criteria for BOI’s other services such as visa application support. Hence what the criteria stand for is vague, creating confusion not only among investors but even within the BOI staffs. It is necessary to clarify legal validity of using minimum investment criteria considering that the criteria are referred for originally-unintended purposes (services other than tax exemption). Also such clarification should be disseminated among the investors.

The BOI Regulation No.2, 2006 was gazette as the guidelines for implementing BOI Act Section 17. This regulation defines the period of tax exemption applied depending on the amount of investment, with the minimum of USD 250,000. In 2011, granting tax exemption based on BOI Act became invalid because of the revision of the IRA. BOI Regulation No.2, 2006 should have been repealed as well as this point since what the regulation defines became invalid. However, the regulation has been continuously referred by BOI officials as criteria for providing other services than originally-intended tax exemption. Moreover, despite of legal invalidity of tax exemption, BOI Regulation no.2 2006 is still posted on the BOI’s web-site creating misunderstanding among investors

In the course of this survey, the survey team recognized the cases where prospective investors referred to this minimum investment criteria and decided not to invest in Sri Lanka because the minimum investment amounts were too high.in case the minimum investments criteria are confirmed invalid, BOI Regulation No.2, 2006 should be deleted from the BOI’s website as well.

To develop high value addition export oriented industries other than tea and apparel, SMEs with high technique should actively be invited, and if this minimum investment criteria is abolished, it should be deleted from the website.

Furthermore, even if minimum investment criteria would be maintained, such amounts should be defined more carefully, considering companies with high-tech niche products are often SMEs. It should be also noted that the initial investments are not the only value the investors could create. They could possibly cater more values after starting business in Sri Lanka by way of export, employment and re-investment.

S2: Revise Incentive Design by Compliment Services for Post-Investment

Sri Lanka should review a design of incentives to the investors, in accordance to recent global trends where incentives are provided after the investment in a “non-tax” form.

Because each project has different challenges and bottlenecks, a traditional uniformly packaged incentives are becoming obsolete. Rather the investors prefer an “order-made incentives” to respond to different needs of each investment.

The amendment of IRA is being discussed as of August 2017, where it is said that the Ministry of Finance will solely administrate tax issues and tax holidays will not be granted any more in principle. Thus future investment policy should give more focus on creating better business environment after the investment to promote expansion /re-investments. It should be also noted that such non-tax incentives need to be designed in a way that the prioritized industries would attract increasing FDI.

Furthermore, in providing above incentives, close coordination among different line ministries will be required.

S3: Incorporate Information on the Latest Version of Laws and Regulations

Changes of investment-related regulations and tax administrations are not fully notified to the private sector, as well as to regulation enforcement authorities. This results in confusion in businesses scenes and builds an unfavourable impression of Sri Lankans an investment destination. Some recent examples include frequent and sudden changes of VAT rates in 2016, as well as swinging status of SVAT. Information on changes of laws and regulations should be easily accessed by any investor.

The government of Sri Lanka is putting its efforts to announce regulation changes through multiple media such as gazettes or newspapers. However, investors cannot pay its full attention to all the regulation and tax change notices, browsing websites of different ministries and authorities. Therefore, as a part of investor services, a website should be developed where information on regulatory changes, as well as the latest version of laws and regulations are easily browsed.

S4: Hold Dialogue with Investors (Tax system etc.)

Dialogues should be held between the government and investors for more smooth and effective implementation of business-related laws and regulations. Through such dialogues, the authorities could obtain inputs from the investors to reflect on laws and regulations. At the same time, the investors could understand the background and rationale of regulatory changes more properly, minimizing confusion and misunderstanding at the implementation stage.

More practically, an annual or bi-annual caucus should be held between the Sri Lankan government and the investors focusing on tax regulation and their prospective changes. Given its complexity, a caucus focused on a tax system could be held separately by the finance ministry.

In case of Japanese investors, there is an existing framework of joint forum with Sri Lankan Authorities. The above mentioned caucus could separately held focusing more on tax system and legal issues.

(2) Medium Term

M1: Strengthening BOI's Function to Promote Investment and re-Investment

The BOI, currently the main agency of FDI promotion, has been operating as an incentive granting organization in reality.

The role of the One Stop Shop offered by BOI since February 2016 remains ambiguous, and it was heard from investors that they hesitate to consult with the OSS because of such ambiguous mandate. The government of Sri Lanka needs to elaborate BOI's role and function and to define strategy with measurable key performance indicators. Also the relationship between BOI and its superior and/or peer organizations should be clear to any investors.

Generally speaking, roles of investment promotion agencies are defined as a) induce new investment, b) arrange incentives for investors and c) encourage re-investment. The uniformly packaged incentive programs are gradually declining abolished in the global trend and shifting to case-by case arrangement. Also, the focus of incentives are more on reduction of operational cost rather than that of initial capital cost. Following such global trends, the function of BOI to promote re-investment needs to be strengthened.

M2: Introduce Mandatory Notice Period of regulatory Changes for at least 3-6 Months

As discussed in 3.5.2, investors have been losing confidence on tax administration due to frequent and sudden changes. This results in stagnated tax revenue.

To minimize negative impacts of such changes, mandatory notice period of three to six months should be introduced. Three-month notice period can be imposed on regulatory changes without retroactive application, and 6 months with retroactive application.

5.2.2 Business Infrastructure

Although investors in Sri Lanka are generally satisfied with the quality of infrastructure, some mentioned the challenges due to lack of land in EPZs. Also investors in general mentioned the high quality of Sri Lankan labour with good learning speed. However, investors suffered from a scarcity of skilled labour forces. The country has to strategically plan developing business infrastructure in the long term to accumulate export-oriented investment. It should be noted that the responsibility of business infrastructure development should not be borne solely by public, but by combined efforts with private sectors.

(1) Short Term

S5-1: Maximize EPZs Land Use (1): Consignment Production

To maximize land use of EPZs, rental factory and consignment production outside EPZ are proposed.

There is no regulation defining the EPZ other than BOI Act 1978 which mentions the EPZ as one of the FDI promotion measures. Foreign investors are generally benefitting from EPZs with easier custom procedures and pre-furnished infrastructures. However the occupancy of EPZ is currently very high at more than 90% which made both expansion of existing operation or new entry difficult.

Under such circumstances, companies in EPZs are bringing out raw materials from EPZs premises to production centres outside of EPZs to fabricate. Fabricated goods are then brought back to the EPZs,

inspected and exported to customers. Bringing out the materials outside of EPZs for value addition activities may cause a confusion, because EPZs are designated as bonded area. However, the BOI allows such arrangements currently as an exception due to imperative needs from the investors who wish to expand their production.

It is recommended that such practice be formalized by official regulations until a new EPZ is developed. The production centres outside of EPZs should be treated as a bonded area, applying the same standards and requirements as other existing bonded areas.

S5-2: Maximize EPZs Land Use (2): Rental Factory

To deal with the shortage of EPZ land availability, a rental factory is recommended, considering successful practices in the South East Asian countries such as Vietnam and Cambodia.

Rental factory is a sub-let facility, usually at a small scales, for manufacturer's operation with minimum utilities pre-installed such as electricity, gas and water. Rental factory enables investors to minimize initial investment capital cost and time to start operation. In South East Asia, typically follower companies in automotive and electronics industries choose a rental factories to deploy. Three major benefits of utilizing a rental factory are as follows:

1) Rental factory can be manufacturing base for SMEs, by its nature, usually do not invest at a large scale. IN ASEAN, rental factories have gained popularity among SMEs minimum are and minimum contract period are much smaller and shorter than those of industrial parks, matching with small-scale production.

2) Rental factory can be a base for manufacturing testing. Normally, building a production base is a major investment decision, and it is difficult to withdraw once advanced. However, in case of utilizing a rental factory, it is possible to withdraw in a short period of time, if the activities in the country do not go well. Thus, investors can utilize rental factories for testing purposes.

3) Rental factory enables quick business commencement. Normally, when entering an industrial estate, it takes a certain time to construct however, using a rental factory, production can be commenced in about a few months.

It is also noted that rental factories have benefits not only for investors, but also for Sri Lankan side. It could attract investment from SMEs that might have given up investment in the past. It should be noted that many companies are SMEs that have high-tech niche products supposedly suitable for Sri Lanka to foster. In the case of electronics and electric and automobile parts manufacturing, with plenty of successful examples in the South East Asia rental factory shall be a powerful tool to attract these industries.

However, operating rental factories requires certain amount of experiences in contract management. Therefore, it is recommended to invite private developers/operators that have relevant skills and experiences.

Since it generally takes time to build a new industrial park, it is recommended to introduce rental factory within an existing EPZs in the short term¹⁴⁰, and develop a new EPZ/Industrial Park in the medium to long term.

¹⁴⁰ As an existing industrial park, in addition to the industrial park where there is currently vacancy, land might be available even in fully occupied industrial park, if vacancy is generated due to the withdrawal of enterprise. Therefore, using such vacant land would also be considered for the development of rental factory.

S6: Facilitate Investors' Involvement in Skill Education

One of Sri Lanka's attractiveness as an investment destination is the relatively high education level of labour forces. However, the supply of labour forces is limited. Sri Lanka should broaden skilled labour force base to provide sufficient labour forces for the value addition export industry. Also the quality of labour force can be further improved by providing basic skilled education at earlier stage.

As written in 4.1.2, Sri Lanka has several public vocational schools. The curricula of these schools are mostly developed internally within the schools and implications from the industry are hardly observed. To address such issues, the Skills Sector Enhancement Program with TVET (technical and vocational education and training) supported by the ADB is facilitate four industries (construction, tourism and hospitality, information technology and light engineering manufacturing). However, interviews with existing investors suggested there is a room for improvement. Currently, public schools receive five times more applicants than its capacities and accepts four times more than it's originally established and design its facilities. However, half of their graduates find jobs outside of Sri Lanka. On the other hand, investors provide training with their workers at their own expenses which are becoming significant burden year by year. To resolve this situation, following actions are recommended.

A private vocational school such as NIBM (National Institute of Business Management)¹⁴¹ accommodates training courses conducted by the investors on basic SMET (Science, Mathematics, Engineering and Technologies) education, covering subjects such as material engineering, robotics, micro-precision processing, plasticity and moulding engineering and thermal engineering in addition to production management. The graduates of the courses will be provided employment opportunities working for the investors that have conducted the courses. Investors can also benefit from this arrangement because reaching with skilled labour better equipped with basic SMET, internal training of each company can be much shortened.

Secretariat role could be assumed by organizations like JASTECA (Japan Sri Lanka Technical and Cultural Association)¹⁴², an alumni organization of trainee in JICA or HIDA programs.

(2) Medium Term

M3: Improve Legal Framework for EPZs/IPs

According to BOI Law (1978), there are three sets regulations on the development of industrial parks by BOI. There are three types of industrial parks /zones in Sri Lanka: BOI operated zones, BOI and private sector jointly operated zones, and 100% private operated zone. However, specific differences between EPZ and IP, as well as specific procedures on the establishment of enterprises in EPZ are not clearly stated.

If the government of Sri Lanka intends to promote industrial park development involving private sectors in the future, it is necessary to set clear standards to stipulate critical factors including responsibility sharing.

¹⁴¹ NIBM: NIBM is a private vocational school running courses in business administration, computer, foreign language, technology and industrial design in five campuses nationwide.

¹⁴² JASTECA: JASTECA is an alumni organization who learned in Japan through JICA and/or HIDA program in Japan to exchange personnel.

Because it takes time to develop such regulations and legal framework this task is categorized as a medium term action.

M4: Develop new EPZs/IPs with more Private Sector Involvement

Sri Lankan EPZs are superior in its utility setting and land costs compared to the major ASEAN countries. However 95% of existing EPZs in Sri Lanka are occupied leaving handful land for expansion and new entry. New EPZs development is necessary.

Existing EPZs development were primarily developed and operated by the BOI. However, inviting private industrial park developers may accelerate development. In addition to what was discussed in M3, legal framework for Public-Private partnership (PPP) also needs to be developed. Additionally, living and working environment of workers in the EPZs should be properly regulated.

In terms of newly developed EPZs, it is recommended to locate them to areas other than the Western region, possibly along the economic corridors, bearing in mind the balanced development promoted by PIP.

M5: Utilize Potential Labour Forces in Rural Area

Major vocational training institutions and their graduates are concentrated in Colombo area. However, a shortage of labour in Colombo area is becoming obvious. To tackle this situation, utilizing potential labour force in rural areas is essential. It is recommended to mobilize those who have worked in EPZs and retired (typically female workers) by providing working places in the vicinity of their current residing areas. Locating consignment production (S5-1) in rural area can be option to realize this measure.

5.2.3 Industry development

The government of Sri Lanka recognizes the necessity of promoting high value addition export oriented industry

BOI and several other organizations are undertaking industry assessment supported by organizations such as the World Bank and Harvard University. From the selected eleven industries discussed in 4.2.1., the government of Sri Lanka needs to further narrow them down to a few prioritized industries and to formulate a master plan for each of them as initial step to realize industrial development.

(1) Short Term

S7: Select a Few Prioritized Industries

Following the industry assessments done by different organizations, the government of Sri Lanka should select a few prioritized industries and develop concrete plans for how they would be promoted. In addition to common understanding that prioritized industries must be high value addition, the two additional criteria are proposed. These are: 1) existence of successful investors in Sri Lanka and 2) have potential for fostering supporting industry.

Existence of successful investors is important in two aspects. First, it could convince new investors of entering Sri Lanka much easier because they could see similar investment is proven successful before they actually enter Sri Lanka.

Secondly, by obtaining inputs from existing investors, investment promotion policy could be formulated more quickly and precisely.

As seen in anywhere else in the world, fostering supporting industry could boost export and employment. Also, inviting or developing immediate up- or down-stream of value chain transaction value in the industry will be increased exponentially. Therefore an industry with large supporting industry should be chosen as priority industry. It is noted that such employment creation could contribute to the goal of “One Million Jobs” mentioned in the Prime Minister’s speech in 2015. Automotive parts and electronic components manufacturing match the above two criteria.

M6: Formulate Master plan of Prioritized Industries

After nominating prioritized industries, a master plan for each industry should be developed and shared with relevant ministries and agencies across the government.

A few sectors have formulated master plans so far. For example, the rubber sector master plan was prepared in 2017, summarizing the strategy in next 10 years. However, most of other industries do not have such master plan. Therefore, for selected priority industries, line ministries, in collaboration with BOI and EDB should prepare a master plans by defining the development objectives, identifying issues and challenges for attracting investment and drawing up strategies to be taken with proper monitoring indicators.

It should be noted that, especially with newly developing industries, a line ministry may not be clear. Therefore, on selecting prioritized industries, the government should assign specific ministry for each selected industry without delay.

S8: Conduct PR Activities for Investors (road show, business matching, etc.)

Investment promotion activities are proposed as follows to lead attract more investors;

(1) Introducing Successful Cases

Invite successful existing investors to elaborate key success factors to potential investors and promote the Sri Lanka’s business environment. For Example, some investors in Sri Lanka export their high-end products to the market where they compete against European and/or US firms. Disseminating such successful precedence, together with the fact that those products are manufactured by qualified Sri Lankan workers, will be a good promotion.

(2) Matching Prospective Investors with Local Partners

In case of promotion for Japanese companies’, it is difficult to differentiate Sri Lanka from other South Asian countries, and not fully regarded its attractiveness and superiority as an investment destination. However, once the company has correct understanding on the country’s features, chances are high that more investors would be interested in Sri Lanka. A joint delegation of Sri Lankan officials and private sectors that promote strong points of Sri Lanka could cultivate more interest among Japanese investors.

(3) Matching Prospective Investors with Local Partners

Successful investors often have reliable local business partner. Generally speaking, Sri Lankan firms are interested in technology and thus willing to explore partnering opportunities with foreign investors. Hence, creating matching opportunities is important. The rental factory discussed in S5-2 may increase matching opportunity during the period investors are testing their business suitability with Sri Lankan business environment.

(4) Seminar Organization

In case of promotion for Japanese investors, Japanese side such as JETRO or chamber of commerce could also play a role to promote Sri Lanka as a production centre of high-end products. It should be noted that SMEs often have niche high-technologies and are relatively fast in decision making decisions.

5.3 Stakeholders' Response to the Proposed Action Plan

To share the findings of this survey and reflect stakeholders' inputs on the action plan, a seminar was conducted. Major comments and opinions were as follows.

(1) Re-examination of the minimum investment criteria and clarification of criteria

Regarding the action plan S1 on minimum investment re-examination, multiple participants suggested that the amount USD 250,000 needs to be re-examined, with considerations on characteristics of specific industries and on promotion of SMEs' investment to the country. Additionally, a comment from a Sri Lankan private sector was made that there is confusion among the private sector on information on the BOI's website, regarding the implementation of minimum investment criteria and the effectiveness of BOI regulation 2006. This shed light on the need to clarify effectiveness of the regulation, as well as to improve methods of disseminating such information.

(2) Strengthening of the BOI function

The action plan S-2 and M-1 suggested needs of strengthening functions of BOI in investment promotion and support to existing investors. Although this suggestion received support from many participants including the BOI, a representative from BOI expressed concerns that, to improve the situation, many factors are out of BOI's control. For instance, regarding withdrawal of outdated information on minimum investment criteria from its website, BOI commented it is difficult to do so without clear direction given by the government.

(3) Introducing rental factory and consignment production

Maximizing land-use of EPZs, (S-5) introduction of rental factories and formalizing consignment production received generally positive reaction. This was due to anticipation to invite high-tech niche SMEs to the country. Examples of consignment production outside of EPZs were shared by participants from private sector. Positive comments were received for concepts proposed by the survey team such as improving production capacity outside of central Colombo, and facilitating female labour force.

On the other hand, inputs were given that the environments within and around the EPZ (e.g. living environment of workers of the EPZ) needed to be improved. Also, for the operation of rental factories, there was a suggestion to develop and operate within PPP framework.

(4) Investors' involvement with skill education and industrial labour force development

The findings that the skill levels of labour in Sri Lanka is highly valued by investors, but the issue lying in the lack of supply of these workers received wide supports from the participants. Participants from private sector shared examples of human resource development within their companies, and supported the suggestion made by the survey team on enhancing company/ investor involvement in vocational training in Sri Lanka. The suggestion included provision of knowledge and instructors from the private sector, enlarging the pool of technical labour force, and encouraging the employment of female workforces.

(5) Selection of priority industries

The proposed action to select prioritized industries and to formulate master plan (S-7) received support from both private and public participants. BOI reminded that the importance of getting political support for such industry promotion. BOI also stated that it is in the process of selecting priority industries within BOI, giving priorities over IT/BPO, high value addition apparel/food processing, tourism, and logistics services.

Attachments

1 Legislative Systems

1.1 Registration of incorporation

Registration procedures of incorporation are specified in Article 4 of the Companies Act and thereafter.

Step 1: Decision of the company name

View the Registrar of Companies (ROC) database¹⁴³ or register, submit an application¹⁴⁴ to the ROC that states that the name of the company is not identical or similar to any other existing company it plans to register, and reserve it. The application can be submitted via ROC website or in writing to the ROC and it will be approved based on the application.

Step 2: Appointment of the director and secretary

Companies Act Article 4.1 and thereafter stipulates that all companies maintain registration under the names of director and secretary¹⁴⁵. The secretary shall be employed before the incorporation of the company and written consent from the secretary and director need to be prepared.

Step 3: Application for registration

Four types of documents below need to be submitted to the ROC and registration fees¹⁴⁶ need to be paid to complete the application.

- Company's Article¹⁴⁷
- Application of company registration (Form 1)
- Consent of all Directors (Form 18)
- Consent of Secretaries (Form 19)

Step 4: Public notice

The establishment of the company is announced publicly in the Gazette or at least one daily newspaper within 30 days after its registration.

After the incorporation of a company, it needs to obtain a taxpayer identification number (TIN)¹⁴⁸ and register as a value added tax (VTA) business operator with the IRD and obtain the EPF¹⁴⁹ and ETF¹⁵⁰ from

¹⁴³ <http://www.drc.gov.lk/App/comreg.nsf?Open>

¹⁴⁴ Refer to Companies Act Articles 6 and 7 for the rule of company names.

¹⁴⁵ The secretary is a post not provided in Japanese Companies Act and he/she keeps records required under Sri Lankan Companies Act. One secretary is required to be appointed regardless of the type of the company before its establishment. The appointment and removal thereafter is decided by the board of directors unless provided specifically.

¹⁴⁶ The registration fees of a limited liability company areas around 19,980.00 LKR. (Form 1 - 15,000 LKR, Form 18: 1000 LKR /Form 19: 1000 LKR, Articles of Association: : 1000 LKR, VAT: 15% of the total amount). After the year of establishment, annual registration fees are required to be paid (60,000 LKR for a limited liability company and 500,000 LKR for an unlimited company)

¹⁴⁷ Standard form can be found in Article 7 of Companies Act.

¹⁴⁸ The application form can be obtained from the IRD website (<http://www.ird.gov.lk/>) or at its office.

¹⁴⁹ It is the abbreviation of Employee's Provident Fund. It is a fund established to guarantee living of employees after retirement from private or public companies. See labour and visa scheme for details.

¹⁵⁰ It is the abbreviation of Employee's Trust Fund. It is a fund established to guarantee living after unemployment and

the Department of Labour. It also needs to open a securities investment account (SIA)¹⁵¹ for investing in Sri Lanka from overseas or an inward investment account (IIA)¹⁵² to establish a branch office or representative office.

1.2 Inland Revenue Act (IRA) and corporate tax

Calculation of corporate tax

The taxable income is computed by making certain adjustments to the accounting profits as per the audited financial statements prepared for each fiscal year¹⁵³ (April to March) as provided for in the IRA.

These accounting profits are adjusted as per the provisions of the IRA, where expenses that are disallowed are added back and expenses that are specifically allowed are taken as a deduction from accounting profits.

Examples of specific tax adjustment items include the below.

- Advertising expenses are allowed only up to 75% of the cost
- Entertainment expenses are completely disallowed
- Salaries of employees are allowed even though no specific mention is made in the domestic law, provided employment tax is duly paid.
- Management fees can be deducted up to 1% of the turnover or 2 million LKR, whichever is lower
- Foreign travel expenses can be deducted only up to 2% of the profits and income from trade in the previous year
- Expenses of a capital nature are disallowed
- Thin capitalization rules

Payment of corporate tax

Generally, income tax is payable in four equal quarterly instalments on a self-assessment basis. The entity would have to pay tax on taxable profits based on a preceding year or on a current year basis. The current year basis is used where it is possible to estimate the results for the year and it is expected that the current year will have a tax loss or a reduced tax profit. In such case, 1/4th of the estimated tax liability for the current year should be paid as a quarterly instalment. Otherwise, 1/4th of the final tax liability for the preceding year is paid as a quarterly instalment.

Please note that the current year basis of discharging taxes does not give the flexibility of making the final payment in September. The mode of discharging taxes would be as follows:

retirement. See labour and visa scheme for details.

¹⁵¹ It is the abbreviation of Security Investment Account. It is an account to receive and pay money from and to overseas enabling transfer of dividends without prior approval of the Foreign Exchange Act. It can be opened at authorized foreign exchange banks.

¹⁵² It is the abbreviation of Inward Investment Account. Foreign currencies necessary for maintaining a branch or representative office, etc., of a foreign company are transferred in Rupee to the account. When a company is registered in view of business activities, a proof of transferring money equivalent to at least USD 200,000 needs to be submitted to the ROC within 30 days after the date of registration.

¹⁵³ A special permit needs to be obtained from the IRD to produce the financial statements based on the calendar year and use the term for calculating the taxable income.

- 1st Instalment- on or before the 15th day of the month of August in that relevant year
- 2nd Instalment- on or before the 15th day of the month of November in that relevant year
- 3rd Instalment- on or before the 15th day of the month of February in the following year
- 4th Instalment- on or before the 15th day of the month of May in the following year
- Final Instalment- on or before the 30th day of the month of September in the following year

E.g.: Year of assessment 2016/2017

- 1st instalment - August 15, 2016
- 2nd instalment - November 15, 2016
- 3rd instalment- February 15, 2017
- 4th instalment- May 15, 2017
- Final instalment - September 30, 2017

Filing the Income Tax Return

Every Company is required to furnish a corporate Income Tax Return for a given year of assessment together with audited financial statement and schedules on or before November 30, of the year after the respective year of assessment. (E.g. The Income Tax Return for the year of assessment 2016/2017 should be filed on or before November 30, 2017.)

Penalties for Taxes in Default and Non-Compliance

① Taxes in default

Any person who has not paid the quarterly instalments on or before the due dates is liable to a penalty. A penalty of 10% is imposed on the tax not paid on or before the due date. If tax is not paid within 30 days of default, a further penalty of 2% is added for every 30 days or part thereof, up to a maximum of 50% of the tax in default.

② Non-compliance

The Commissioner General may impose a penalty not exceeding 50,000/= LKR if the company fails to furnish the return on or before the due date. In the case of incorrect returns, if an assessment is issued to a company challenging a claim or for wilful default and it becomes final and conclusive, such company will have to pay a sum not exceeding the aggregate of 2000/= LKR and a sum equal to twice the tax on the amount of the excess, as penalty.

Assessments and Appeals

If, in the opinion of the Assessor, a person who is liable to pay income tax has not paid or has paid less than the amount which ought to have been paid, an assessment can be raised. Therefore, an assessment can be made either by accepting the return or not accepting the return.

Thus, if the return filed by the company has not been accepted by the Assessor, an assessment may be issued, but the reasons for not accepting the return should be communicated before or around the time of

making such assessment.

If the company is aggrieved with the assessment, the company can appeal against the same:

- Stage 1 – Appeals to Commissioner General of Inland Revenue
- Stage 2 – Appeals to the Tax Appeal Commission
- Stage 3 – Appeals to the Court of Appeal
- Stage 4 – Appeals to the Supreme Court

1.3 Value Added Tax (VAT) Act

Calculation of VAT

The value of supply of goods or services shall be, where for the consideration in money, be such consideration excluding any VAT charged under the Act, but shall not be less than the open market value of such goods and services.

- Output tax - the tax chargeable in respect of the supply of goods or services made or deemed to be made by a registered person.
- Input tax - VAT paid at the point of import and on purchases of goods and services. Input VAT on local purchases can be claimed within twelve months from the date of invoice whilst the input VAT on imports can be claimed within twenty four months from the date of the customs declaration

In calculating the amount of VAT payable to the IRD the proposed entity can deduct the input VAT from the output VAT up to 100% of the output VAT in that given taxable period, subject to restrictions under the VAT Act and availability of proper documents.

E.g. – VAT on supplies (Output VAT) = 100
 Less: VAT on purchases (Input VAT) = (20)
 VAT payable = 80

The revenue authorities will not refund any excess input VAT on the proposed investment. However, the excess can be carried forward to be set off against future periods.

Time of Supply

The time of supply is when VAT falls due or the point of taxation. The time of supply is the earlier of the following:

- Date of invoice
- Due date of payment
- Date of receipt of payment/advance
- Date of performance of services (if the invoice is issued within 10 days of the performance of the service, then the time of supply is considered the date of invoice) or the date of the delivery of the goods

Payment of VAT

VAT is payable on a fortnightly basis by certain investment including service. Accordingly, payments should be made as follows;

- From the 1st – 15th of a month - on or before the end of the month
- From the 16th - end of a month - on or before 15th day of the following month

Filing the Return

Every registered person should furnish a Return to the Commissioner General no later than the last day of the month after the expiry of each taxable period.

Penalty for Taxes in Default and Non-Compliance

① Taxes in default

A penalty of 10% of the tax in default and a further penalty of 2% would be charged for every 30 days or part thereof in default thereafter. However, the total penalty should not exceed 100% of tax in default. The Commissioner General may impose a penalty not exceeding 50,000/= LKR if the company fails to furnish the return on or before the due date.

② Non-compliance

A penalty of 25, 000/- LKR may be imposed on those who fail to register in a timely manner.

1.4 Nation Building Tax (NBT) Act

Liable Turnover

- Imports; The value of the article ascertained for the purpose of Value Added Tax.
- Manufacture; The sum receivable, whether received or not, from the sale in Sri Lanka in any relevant quarter of every article manufactured.
- Service Providers; The sum receivable, whether received or not, from the provision in Sri Lanka of any service.
- Wholesale or retail trade; The sum receivable, whether received or not, from the sale in that quarter of any article other than -
 - ✓ Certain pharmaceuticals
 - ✓ Any article subject to the Special Commodity Levy, sold unprocessed
 - ✓ Gems or jewellery, sold for payment in foreign currency with the authorization of the CBSL
 - ✓ Any printed book
 - ✓ Any article exported
 - ✓ Any article sold to any exporter for export
 - ✓ Fresh milk, green leaf, cinnamon or rubber (latex, crepe or sheet rubber) purchased from any manufacturer or producer thereof
 - ✓ Petrol, diesel or kerosene sold in a filling station, etc.

The following adjustments have to be made to the liable turnover from manufacture, services and wholesale and retail trade.

(Deduct)

- Any bad debt incurred in the relevant quarter
- Any Value Added Tax paid in the relevant quarter
- Any excise Duty paid in the relevant quarter, other than such excise duty paid on the importation with effect from February 1, 2009
- Rebate paid under the Export Development Rebate Scheme in relation to any international event, as approved by the Minister of Finance
- Any turnover from the supply of any goods or services in relation to any international event, as approved by the Minister of Finance.

(Add)

Any bad debt recovered in the relevant quarter

Calculation of NBT

As described earlier, the NBT is imposed by applying the proper tax rate on responsible sales. Different from the VAT system, the NBT Act has no scheme of offsetting the NBT liability with NBT credits (excluding the case of manufacturers). Thus, the NBT to be paid upon purchase is the cost for the company. If the supply chain becomes longer, aggregate amount of NBT will be accumulated (that is, cascading effect).

Also different from the VAT system, the NBT Act has no provision on having customers bear the NBT liability. The company decides whether to collect NBT liabilities from them. When a company chooses to collect the liability from its customers, the amount of collected NBT needs to be added to the calculation of sales on which NBT is imposed (e.g. added at the tax rate of 2.04%).

Payment of NBT

Due to be paid on or before the 20th of the following month.

Filing the return

Every Company is required to furnish NBT Returns on a quarterly basis. Such return for any relevant quarter must be furnished on or before the 20th of the month immediately succeeding the end of that relevant quarter.

Unlike Income Tax which follows the fiscal year NBT adopts the calendar year. Accordingly, a 'quarter' herein refers to a period of three months commencing on the first day of January, April, July or October of any year.

E.g.: Year 2017 – First Quarter (period from January 1, 2017 to March 31, 2017)

Payment dates

1st instalment – February 20, 2017

2nd instalment – March 20, 2017

3rd instalment – April 20, 2017

Return Filing – April 20, 2017

Penalty for Default or Non-Compliance

The penalties are the same as mentioned above in relation to corporate income tax.

1.5 Economic Service Charge (ESC) Act

Payment of Tax

Generally, ESC is payable on a self-assessment basis in four quarterly instalments. Payments should be made as follows;

- Quarter 1 - on or before 20th July
- Quarter 2 - on or before 20th October
- Quarter 3 - on or before 20th January
- Quarter 4 - on or before 20th April

ESC is similar to an advance payment of income tax and can be set off against the income tax liability (if any) and any excess can be carried forward for 4 years.

Filing the Return

Every person chargeable with ESC should furnish a return of ESC on or before the 20th day of the month immediately succeeding the end of that year of assessment.

E.g. Quarter 1 – Year of assessment 2016/2017

- Period from January 1, 2016 – March 31, 2016 (for a company adopting December year-end)
- Payment date – July 20, 2016

Penalty for Taxes in Default and Non-Compliance

The penalties are the same as mentioned above in relation to corporate income tax.

2 Seminar Records

1.1 Overview and Aim

Reporting of the survey findings and proposal to improve the investment climate of Sri Lanka.

■Objective of seminar

To proposed the action plans retrieved from the information collection survey to government organizations in charge of direct investment promotion in Sri Lanka, and agree on actions to realize the

proposals. Additionally, to invite private sectors that may grope business expansion from improvement of investment promotion, skilled labour development, introduction of rental factories/consignment production and receive their comments.

Planned overview, and programme of the seminar was as below.

■Seminar overview

| | |
|-------|--|
| Date | 9 : 00-11 : 35, July 18 th (Tue), 2017 |
| Venue | Ivy Room, Cinnamon Grand Colombo, 77, Galle Road, Colombo 3, Sri Lanka |

■Programme

| Time | Title |
|--------------------------------|--|
| 08 : 30 – 09 : 00 | Registration |
| 09 : 00 – 09 : 05 (5 mins) | 1. Opening Speech JICA Chief Representative |
| 09 : 05 – 09 : 45 (40 mins) | 2. Survey Results Ernst & Young Advisory and Consulting Co., Ltd. |
| 09 : 45 – 10 : 05 (20 mins) | 3. Comments on Survey Result and Future FDI and Industrial Policies Ministry of Development Strategies and International Trade |
| 10 : 05 - 10 : 20 | Break |
| 10 : 20 – 10 : 50 (30 mins) | 4. Panel Discussion – Investment Climate of Sri Lanka from Investors Point of View Tos Lanka Co., (PVT) LTD Colombo Dockyard PLC Strategic Management Alliance/ JASTECA Ernst & Young Advisory and Consulting Co., Ltd. |
| 10 : 50 – 11 : 30 (40 mins) | 5. Discussion and Q&A – FDI and Industry Development in Sri Lanka Ministry of Development Strategies and International Trade Board of Investment Sri Lanka Ernst & Young Advisory and Consulting Co., Ltd. |
| 11 : 30 – 11 : 35 (5 mins) | 6. Closing Speech Ernst & Young Advisory and Consulting Co., Ltd. |

The programme was partly amended due to the delay of arrival of speaker from the Ministry of Development Strategies and International Trade.

3. Comments on Survey Result and Future FDI and Industrial Policies was excluded, 5. Discussion and Q&A – FDI and Industry Development in Sri Lanka was replaced by a comment from the Ministry of Strategic Development and International Trade before 4. Panel Discussion – Investment Climate of Sri Lanka from Investors Point of View.

1.2 Attendance

61 attendance (including 10 as organiser) was the turn out, out of 71 expected. Affiliation break down of participants is as follows.

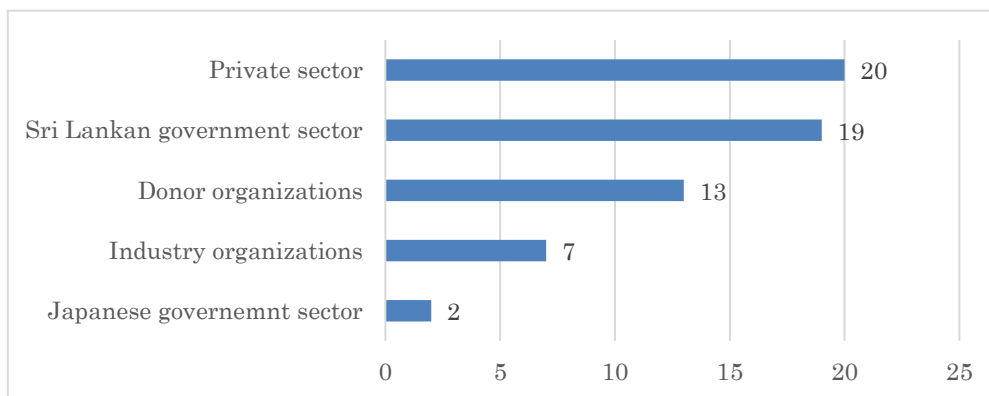


Figure Appendix 1. Seminar attendance breakdown

Attendance from the private sector

Sri Lankan companies: 10 companies, 11 people

- Lawyer, accountant: 3 companies
- Finance, logistics, packing, IT, material processing, electronics manufacturing, and ship building: 1 company each

Japanese companies 5 companies, 9 people

- Building material 2 companies
- Conglomerate, air conditioning equipment, construction 1 company each

(Other 4 people from the survey team)

Sri Lankan government sector

- BOI (including AFD) 10 people
- Central Bank of Sri Lanka 2 people
- Subcommittee on investment 2 people
- Dept. of commerce 2 people
- German Tech, IRD, Dept. of commerce 1 person each

1.3 Contents

Seminar was opened by a speech from the JICA chief representative, followed by explanation of survey results by the survey team. From speakers with different backgrounds such as private companies, private organizations, and explanation on business operations and comments on the survey result was presented. After the break, comments on the overview of Sri Lanka's investment promotion climate was given by the speaker from the Ministry of Development Strategies and International Trade, followed by discussion by the private sector on issues raised as action plans.

1.4 Main comments

Main points discussed during the seminar were as follows;

■ Panel discussion from the private sector

(1) Tos Lanka Co., (PVT) LTD

- Tos Lanka is a 100% Japanese owned company, and manufacture/assemble high value addition electronics.
- To mention the constraints of conducting a high value addition manufacturing in Sri Lanka, the largest constraint is the lack of policy support in developing the industry. In the current industrial policy, high value addition industry is often referred as service, apparel and ICT industries. In some cases electronics industry is grouped in the same category as the apparel industry, but it needs to be reconsidered. When considering development of a high value electronics industry, a comprehensive development policy bearing in mind the clusters such as the optical instrument is expected.
- Electronics manufacturing has integrated automation manufacturing, and covers an important part of the supply chain such as automobile or health care equipment's. The company has had 3 production sights other than the EPZ, of which one was shut down due to logistics difficulties.
- The second constraint lies in the lack of parts manufacturers within Sri Lanka. Tos Lanka needs to import parts from manufacturers in countries such as China, Hong Kong, Singapore, and sometimes India, which creates extra cost such as transport. The development of parts manufacturing within Sri Lanka will increase competitiveness of the industry as a whole.
- The third constraint is the lack of labour to support the high tech industry, and manufacturing industry as a whole. In Sri Lanka, labour tends to flow more to the service and tourism sector, which should be related to the issues of education system in Sri Lanka.
- The fourth constraint is the limited domestic market for electronic parts, especially consumer electronics and telecommunication parts. To solve this issue, Tos Lanka is looking at the South Indian market, where large automobile manufacturers such as Toyota, large consumer electronics manufacturer such as LG locate their factories. Geographically located close, Sri Lanka electronics manufacturers are looking at market opportunities in the South Indian market, hence are expecting national policy support to export of products to India. It is difficult for individual private companies to open a market for South India, therefore a strong leadership from the government such as bringing a group of companies as delegation to support the Sri Lankan manufacturers is needed.

- The fifth constraint is the lack of consistency in the government fiscal and taxation policies. It is still unclear if the SVAT system will continue.
 - The sixth constraint is the lack of national support on R&D. There are needs for existing research institutions and universities to cooperate with the industry in developing technology (especially robotics and nano technology). The government could provide tax exemption for technological development of private companies to enhance R&D investment.
- (2) Colombo Dockyard PLC (CDY)
- CDY is running a shipbuilding and repair in Sri Lanka with finance from Onomichi Dockyard in the past 28 years. In addition to domestic demands, ships are exported to countries such as Malaysia, Singapore, and Dubai, Brazil and have recently received order of cable layer ship to Japan. This shows a good example of the highly valued technology level of the company. On the other hand, there are issues with the skilled labour whom are to support the future of the industry.
 - CDY is collaborating with technological universities and inviting about 500 students to the yard to give training. However, it is financially difficult to run the training facility sustainably internally. CDY welcomes financial support from Japan to set up a training institute, and the company could provide support.
 - Additionally, Sri Lanka is lacking naval architects. CDY receives orders from abroad but there are insufficient number of naval architects. It is very costly to develop a university to train naval architects, so financial support from the government or overseas donors would not only help the ship building industry but also the heavy industry as a whole and the high value addition industry. Since the domestic market is small, it is important to collaborate with the partner in Japan and develop foreign markets.
- (3) JASTECA
- To begin with, it should be strongly noted that the labour force in Sri Lanka potentially has high skill levels. Companies both domestic and foreign highly evaluate the learning speed and loyalty of Sri Lankan workers.
 - The support to Mardana technical college by JICA and the Sri Lankan government in 2010 was a 5 year program under the Ministry of Skills Development and Vocational Training. Its initial aim was to stimulate a national vocational training especially in the mechatronics, metal processing, and ICT sector. However, it lacked input from the business sector on technical know-hows. Training should reflect practical input from private companies, and also provide opportunities for students to learn the working attitude of Japanese companies such as Kaizen (to constantly seek improvement) and 5S.
 - Also, the government, when offering bids should not consider just the initial investment amount but also the long term benefit that business will bring to the country. There was a case where bidding of refrigeration facility for maritime processing, whilst one company aimed at domestic sales of canned fishery product, the other aimed at high value addition processing and exporting. The former business

won the bid because it submitted to pay 50,000 LKR higher monthly for land usage. In this case, the government lost its chance to gain foreign currency, but these chances should not be overlooked in the future.

- The minimum investment amount for BOI is set to be USD 250 thousand, however as 98% of Japanese companies are SMEs, the validity of this amount should be revised. Even if the pilot project is a small amount, there are possibilities for larger investment to follow. To exclude from BOI support due to small initial investment amount is unwise for both Sri Lanka and Japan.
 - The development of a rental factory was introduced in the seminar, of which with the supply of high quality labour and FTA with India, Sri Lanka should be considered a potential investment destination.
 - Sri Lanka should learn from the Nirvana model of India, and develop infrastructure to support the investment of group of Japanese companies.
- Speech from the Ministry of Strategic Development and International Trade
- Points suggested on how to improve the investment climate of Sri Lanka as the result of this survey have been discussed in the government for a long time. Considering the current macro-economic situation, it is clear that Sri Lanka needs to invite more foreign direct investment, especially those that increase export and bring in foreign exchange. In that sense also, Japan is an important country for Sri Lanka.
 - Sri Lanka has missed several opportunities of Japanese investment in the past. With outbreak of the civil war, chances of development missed and political stability lost. Now Sri Lanka needs to proactively work to grab this chance.
 - From the experience in working at CDY, a Japanese company, it is clear that Japanese companies take a long time to analyse the climate before investment, and slowly expand their business afterwards. Sri Lanka should not lean towards short term lower benefit investments, but to consider work on inviting investments that bring larger benefit to the country in the long term. CDY started as a small ship building company, but has now developed to tackle global issues, and manufacture ships with tech wiring to countries such as Japan. This is good proof of the possibility Sri Lanka has.
 - This survey has rated skill labour of Sri Lanka highly, that the workers learn skills in a relatively fast speed. On the other hand, although the quality of labour is high, its number is insufficient. Vocational training with the support of private companies is a very important suggestion that will contribute to the development of investment climate in Sri Lanka. As Japanese manufacturers put emphasis on the concept of Kaizen and Genba (translates as local field), suggestions in this survey does not propose high level policy actions, but give a more practical suggestion based on Genba concept. Participants from the government agencies including the BOI and EDB should proactively accept these proposals and put them into action.
 - BOI has already set up 8 task forces to improve the business climate of Sri Lanka. Although the government aims at reaching 70th rank in the World Banks Ease of Doing Business by 2020, its rank has been dropping 2 years in a row since 2016. Improvement of the investment climate

requires a lot of change, but those changes are needed changes. For example, considering the current macroeconomic situation, it may be difficult to provide the same incentives as the competitors. However it is important that Sri Lanka promote the country, and proactively cooperate with investors.

- Lastly, the government of Sri Lanka has set up a joint working group with the Ministry of Economy, Trade and Industry of Japan, to work on the realization of the road map. Proposals from this survey is planned to be reflected on that road map. It should be strongly advised that all participants should work together to make use of this chance and move towards inviting investment and increase export.

■ Panel discussion by private sector

Q. Efforts of skills development of employees in the company

A1. Colombo Dockyard

- Internally, training needs will be absorbed every year, as well as yearly evaluation and training to all 1,500 employees. Evaluation is for every employees from engineers to managers, and to those who lack skills, additional training is given. Externally, 500 students from NAITA are invited every year as interns, and trained by CDY. Also, over 400 employees have visited Onomichi Dockyard in Japan in the past to go through 6 months training, which then come back, and share their knowledge.

A2. Tos Lanka Co., (PVT) LTD

- Tos Lanka considers human resource development as one of the most important issues. Every year, training needs from employees are absorbed, as well as additional training for engineers. Training results are then evaluated and employees with high scores are sent to Tosslec, the parenting company in Japan, for further training. Assembling of electronic parts, quality management trainings are given for about 6 months, and come back to Sri Lanka.
- Tos Lanka handles surface mount technology, and could also cover maintenance of these machinery, because employees are also trained to speak Japanese, when machines malfunction, they could contact the Japanese manufacturer directly.
- Currently the company does not have any collaboration with educational institutions, but occasionally send staffs to seminars held by governments.

Q. Reason why the country is still facing lack of skilled labour, even with efforts from private companies as mentioned above.

A. JASTECA

- Companies like Tos Lanka and CDY have substantial internal trainings, but that is because private companies partly have the responsibility to train their employees. Looking at the national level, issues change. The apparel industry was a successful example in Sri Lanka, where it developed through training people after graduating from school. The Sri Lankan government needs to acknowledge that there are substantial amount of youth completing A Levels that do not proceed to

university but instead become three wheel drivers.

- The vocational training system introduced by JICA in 2010 was a good idea, where focus was put on mechatronics, ICT, and metal processing. Similarly to this example, necessary training should be given to young people with support from numerous private companies, with the help of JASTECA is necessary. With sufficient education on areas such as mechatronics, ICT, and metal processing, social acceptance towards these industries should also improve.

Comment from the floor: labour and labour environment

- There have been studies by the World Bank and others to show that currently, 60% of the labour force is engaged in the informal sector. Also, ratio of female workable employment is 37%. Reasons to this include discrimination, but how are companies perceiving this situation.
- Also, there are issues with the quality of labour environment surrounding the EPZ. Most employees for the EPZ stay at nearby hostels, where living conditions are poor. Therefore majority of workers perceive working at the EPZ as a temporary job.

Q. (Following the comment) are there efforts to take in female labour

A. Tos Lanka Co., (PVT) LTD

- Ratio of male and female workers in Tos Lanka is about 50:50. When inviting female labour, the company promotes that the products are highly technological machinery and the training system to Japan. In manufacturing industry, most female workers do not have a long term career plan, leaving work after 4-5 years to get married, whilst in Tos Lanka, the company has succeeded in maintaining high skilled female labour.
- There are cases where female workers remain working after marriage, this is due to the continuous training and guidance programmes. Training programme in Japan not only focuses and technical training but also teach employees on life planning.

■

A. JASTECA

- In rural areas of Sri Lanka, there still remains the stereotype that manufacturing is a dirty and harsh work. It is true that there are issues with the living environment of employees. In other countries, there are examples where the companies are regulated to take responsibility in providing living environment for their employees. Unfortunately in the case of BOI, there are no such regulations. Therefore employees have to find their own accommodation, where conditions remain poor. Just like how car parking needs to be considered when constructing a new building, the welfare of employees should be regulated.

■Speech from the BOI

- On behalf of the BOI, it should be commented that the main role of BOI is not to grant incentives, but since the establishment of the organization, tax exemption support has been a part of the organizations duties. In 2011, this authority was passed on to the MOF, where at the same time the

IRD was established. In 2012, the new IRA was published, however in 2014, this new incentive was abolished.

- BOI itself is also having difficulty inviting investment with the above mentioned frequent regulation changes. BOI is currently operating on the amended BOI act of 2006, where the minimum investment amount is mentioned. However since the abolishment of the incentive in 2014, there are no regulations to refer to until today. BOI operates within the authority granted by the government, therefore BOI is also hoping for political stability.
- For priority industries, BOI with the support from the World Bank and the Harvard University group, have worked on the selection. However, it should be noted that the selection is not the important point but to comprehensively develop the industry is needed. At the same time, supporting policies need to be revised for industry development.
- BOI has selected IT/BPO, high value addition apparel and food processing, tourism, and logistics service as priority industries that already exist. In addition development of new industries to increase revenue from exports need to be considered, hence metal products, solar panel manufacturing, pharmaceutical equipment manufacturing, and value addition mineral exports have been chosen.

■Q&A Session

Q. About the function of the BOI

- There are confusion among the minimum investment amount of the BOI. The function of BOI should be a promotion agency, therefore the notice on amendment of the BOI and in 2006 should be revised immediately. There still remains description on tax exemptions and granting incentive, while these regulations have already been abolished and amended.
- Information published is referring to the old information. Even with the limited authority of the BOI, as an investment promotion agency, it should work on what could be done such as update of public notice.

A. BOI

- It is agreeable that the misinformation need to be updated immediately. However until the government decides on which direction the country will invite investment, as BOI needs to reflect the government's intention, BOI needs to wait for the government's announcement.

Comment. About public-private partnership

- In June 2017, the Ministry of Development Strategies and International Trade and the BOI, along with the support from European countries hosted a job fair in Sri Lanka. Japan should also consider similar efforts.
- Private support should also be considered in developing EPZs. For example the use of Public Private Partnerships.

A. BOI

- The job fair was held to promote Sri Lanka to countries in the EU, aimed at supplying labour to companies and to improve recognition of industries.

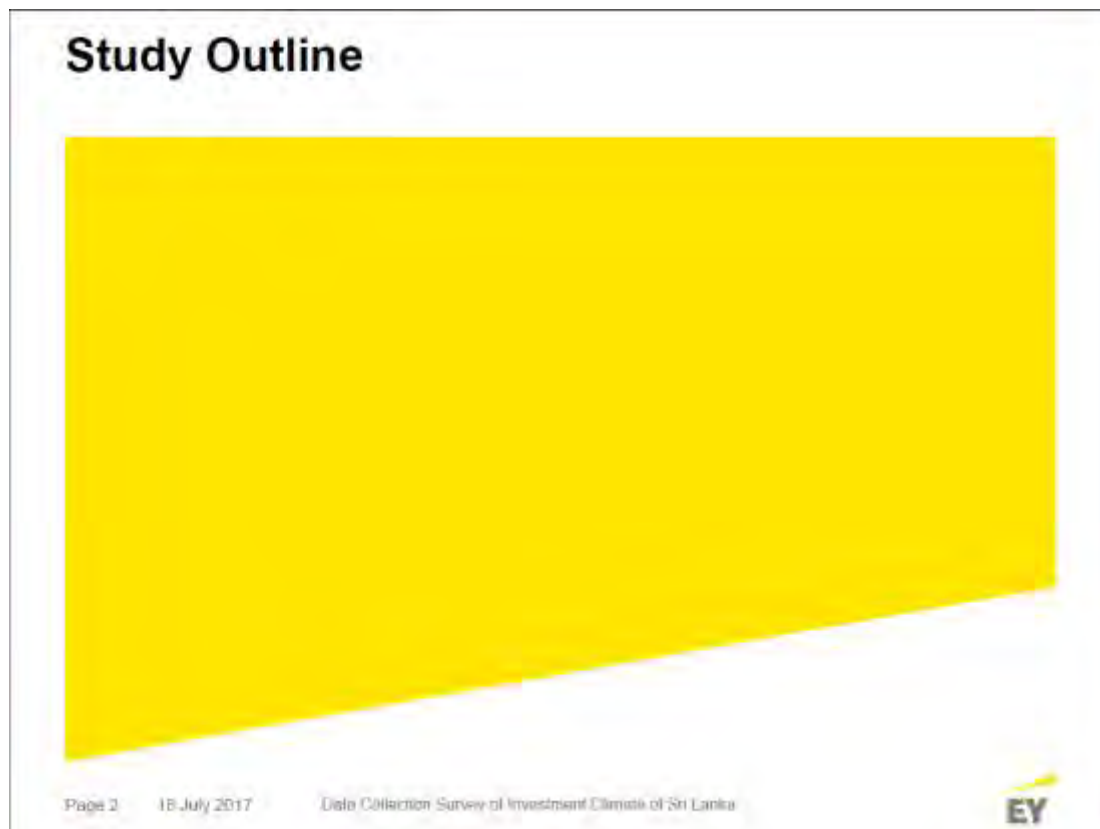
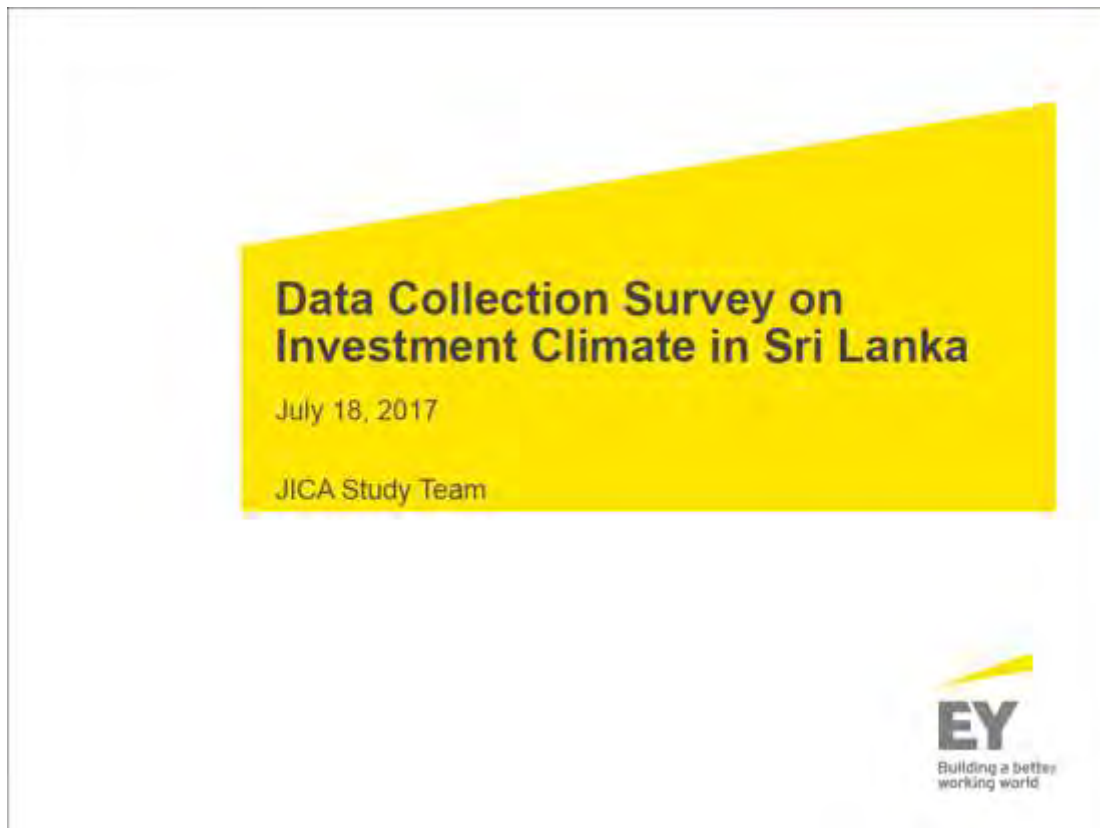
Comment. About minimum investment amount

- As Department of Commerce, there are confusion among the handling of minimum investment criteria. Also to promote investment, selection of industries may be one way, but other perspectives such as land availabilities, electricity supply infrastructures should also be used.

A. BOI

- Currently in the BOI there are several team set up to conduct analysis from numerous angle, and there is a team conductions analysis on land availability. The organization is in its course of development.

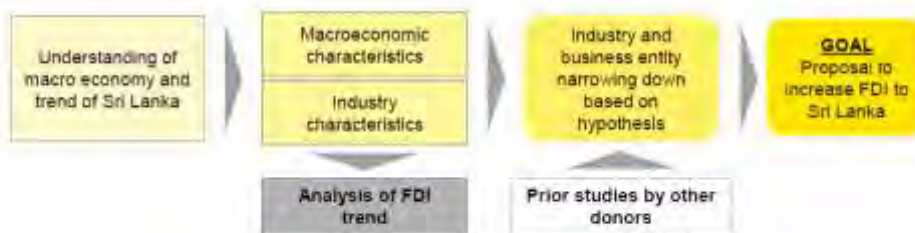
1.5 Seminar slides



Data Collection Survey on Investment Climate in Sri Lanka Research Outline

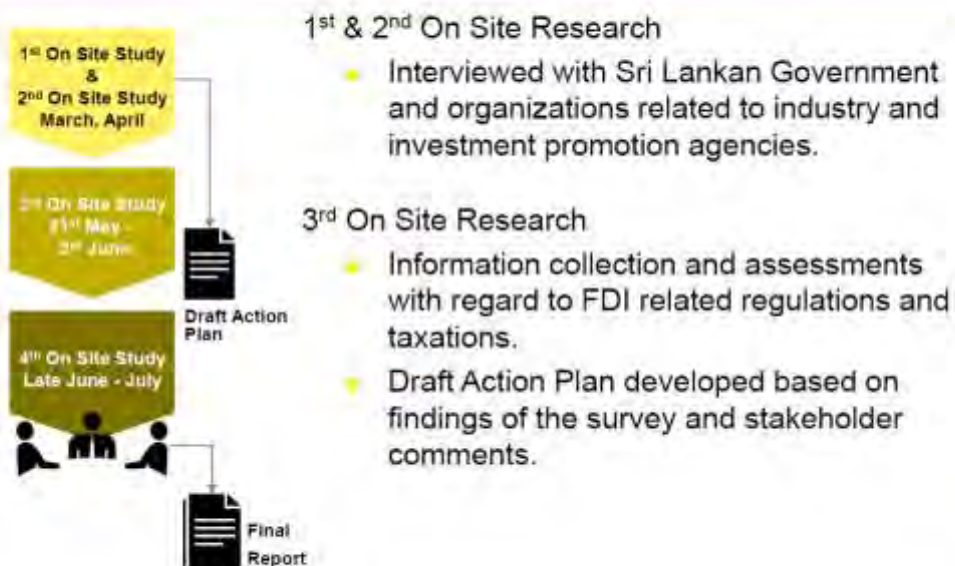
Research Objective

- Collect information and make assessments for FDI promotion
 - Information collection for FDI promotion of Sri Lanka
 (Examine investment potentials and investment promotion schemes)
 - Collect information about Investment Promotion in Sri Lanka
 - Collect comments and feedbacks from Japanese and foreign investors
 - Draft a list of actions to be taken to increase FDI in Sri Lanka



From February 2017 to August 2017

Data Collection Survey on Investment Climate in Sri Lanka Research Flow



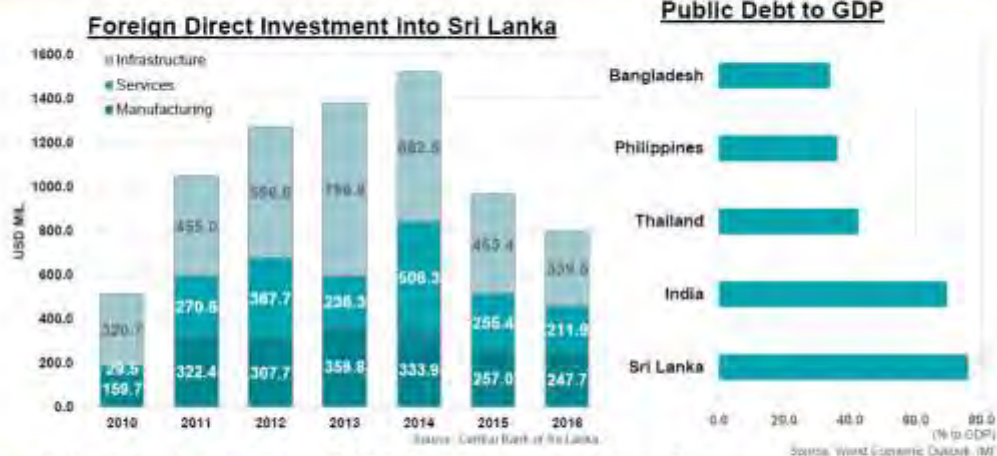
Investment Climate in Sri Lanka



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Importance of FDI for Sri Lanka Macro Economics & FDI



- Infra is the largest part of FDI. Export oriented manufacturing needs to be developed to enhance foreign currency earnings.
- Sri Lanka's Public Debt to GDP proportion stays high. Debt repayment is scheduled to peak between 2019 and 2022.

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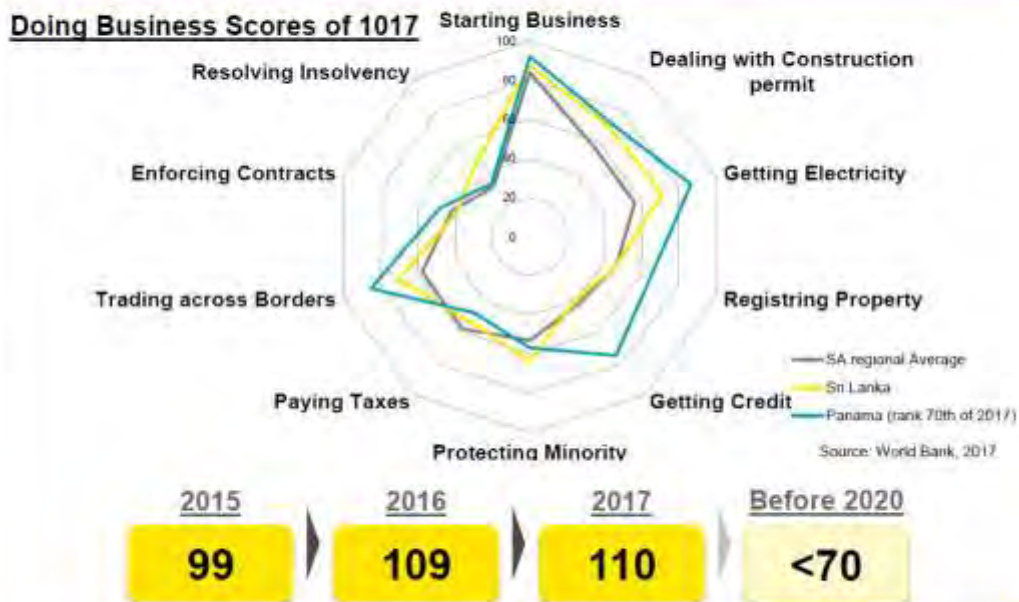


Importance of FDI to Sri Lanka Problem Tree

- Developing export oriented manufacturing industry will contribute not only to generation of foreign earnings to reinforce country's balance of payment, but also to produce positive effects as listed below.



Recognition of Sri Lanka as an FDI Destination -Doing Business Index-



Recognition of Sri Lanka as FDI Destination -Investor Comments-

| Score | 4 Very Attractive | 3 Attractive | 2 Fair | 1 Not Attractive |
|-------|---|--|--|---|
| Items | <ul style="list-style-type: none"> ■ Skilled Labor Quality  | <ul style="list-style-type: none"> □ Ease of doing business □ Quality & Reliability of Infrastructure □ Labor cost □ Living and working environment □ Product demand in neighboring countries | <ul style="list-style-type: none"> ■ Availability of skilled labor ■ Availability of Industrial Land ■ Tax system ■ FDI policy □ Stable political and social environment □ Access to raw materials & suppliers □ Access to business partners □ Ease of appealing to a management of HQ | <ul style="list-style-type: none"> ■ Availability of managerial staffs ■ Legislative and administrative environment □ Product demand in local market |

- Attractiveness → Skilled Labor Quality, Quality of Infrastructures
- Concerns → Labor Availability, Land Availability, Tax & Regulatory Frameworks

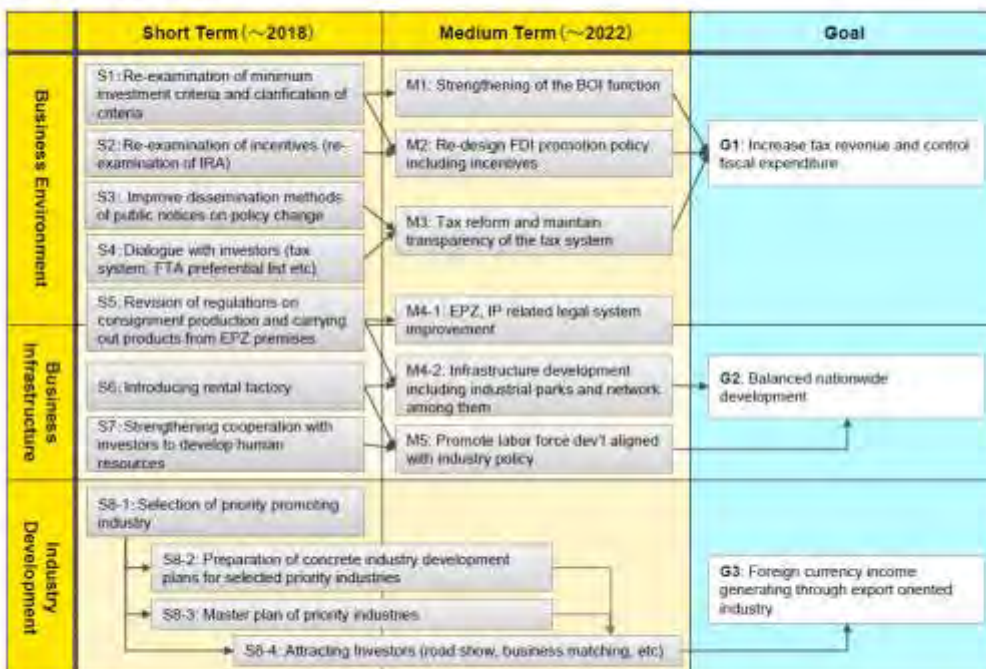
Investors' Evaluation for Sri Lanka -Diverted Investor Comments-

| Country | Industry | Purpose | Reason of Withdraw |
|---------|---------------------|-------------------------------|---|
| Japan | Automobile | Production | The expected market volume in Sri Lanka not sufficient and not feasible for investment. |
| Japan | Electronics | Lighting production and sales | <ul style="list-style-type: none"> → Plant location diverted to Indonesia. → Stopped consideration. |
| Europe | Automobile | Production | Series of obtained approvals were suspended, reviewed due to administration changes . → The consideration are suspended. |
| Japan | Motor-bike | Assembly Production | Company was suggested to hold a target number of export volume. → Export target too high to attain given high custom duties for material import and product export. |
| Japan | Precision Materials | Mobile phone parts production | Tax and custom regulations diverted the investor's decisions → Stopped considerations. |

Action Plan Proposal



Action Plan



Action Plan -Points

| | Short Term (~2018) | Medium Term (~2022) | Goals |
|-----------------------------|--|---------------------|---|
| (1) Business Environment | <ul style="list-style-type: none"> Strengthen institutional capacities Tax and regulatory amendments | | <ul style="list-style-type: none"> Increase tax revenue Control fiscal balance |
| (2) Business Infrastructure | <ul style="list-style-type: none"> Reinforce labor capacities with collaborative efforts Overcome labor and land shortages with innovation | | <ul style="list-style-type: none"> Dedicated to balanced nationwide economic development |
| (3) Industry Development | <ul style="list-style-type: none"> Develop clearer vision of the country's future industry structures | | <ul style="list-style-type: none"> Lead to generating foreign currency income through export oriented industry development |

Action Plan (1) Business Environment

| | Short Term (~2018) | Medium Term (~2022) | Goal |
|--------------------------|---|--|---|
| (1) Business Environment | S1: Re-examination of minimum investment criteria and clarification of criteria | M1: Strengthening of the BOI function | G1: Increase tax revenue and control fiscal expenditure |
| | S2: Re-examination of incentives (re-examination of IRA) | M2: Re-design FDI promotion policy including incentives | |
| | S3: Improve dissemination methods of public notices on policy change | M3: Tax reform and maintain transparency of the tax system | |
| | S4: Dialogue with investors (tax system, FTA preferential list etc) | | |
| | S5: Revision of regulations on consignment production and carrying out products from EPZ premises | M4-1: EPZ, IP related legal system improvement | |

Business Environment S1: Re-examination of Min. Investment Criteria

| | | |
|--|--|--|
| | | |
| | | |

Without tax incentives, what does Article 17 criteria stand for?

| | Before | After |
|--------------------------------|---|--|
| BOI Regulation #2, 2006 | Definition of Eligibility of Tax Exemption to @17 Companies | Definition of Eligibility of Tax Exemption to @17 Companies |
| | Schedule 1, Section 1 provides; ✓ Minimum investment amount US\$250,000 WITH ✓ note of tax exemptions for eligible investors (schedule B) | Schedule 1, Section 1 provides; ✓ Minimum investment amount US\$250,000 WITH ✓ note of tax exemptions for eligible investors |

IRA 2011: Defines tax incentive criteria and supersedes to BOI Regulation #2, 2006

- BOI need to assess and define ...
 1. The validity and status of BOI Regulation No.2, Schedule 1
 2. What the minimum investment is for, and the amount clause in light of targeted industry for promotion

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Business Environment S2: Re-examining Incentive Design

| | | |
|--|--|--|
| | | |
| | | |

Global trend: Post-investment & customized services

- Incentives are provided after the company starts its operation in place.

- Incentives are changing from uniform packaged tax holidays to industry or investors' request basis.

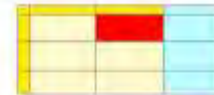
Unformed & Packaged Incentive Offer

Customized services to resolve investors' bottlenecks

- ✓ Land Development
- ✓ Utility Extensions
- ✓ Resource Concessions
- ✓ Public Facilities' Usage etc.

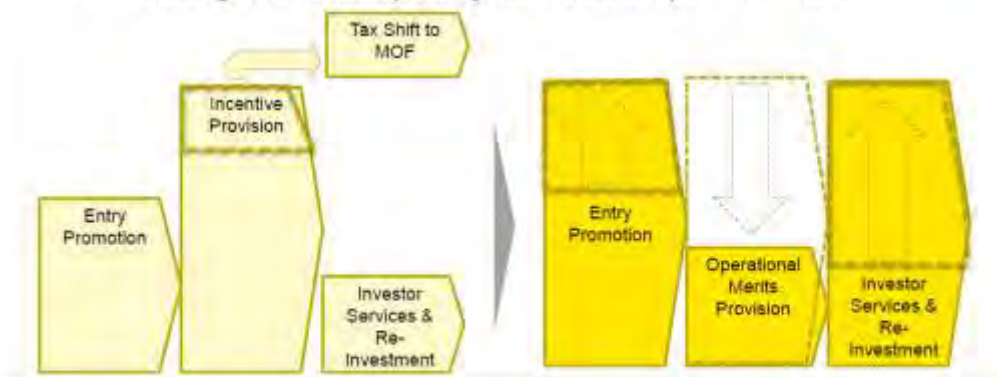
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Business Environment M1: Strengthening of the BOI Function

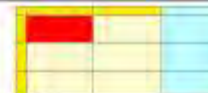


Shift from tax exemption to entry & reinvestment promotion

- Strengthen BOI's function as an investment promotion organization
 - The function of BOI shall shift from tax incentive approval agency to investor service focused agency.
 - BOI shall focus on
 1. Inducing new investors through promotion and entry assistance
 2. Encourage re-investment by existing investors to scale up their investment.



Business Environment S3 & S4: Public Relations of Investment Promotion



Regulation changes need more notice period.

Frequent changes of tax and business regulations
 Short notice
 Scattered information

► Obstruct business predictability
 Confusion among businesses





Business Environment

Cases for S3 & M3: Public notice & tax reform and transparency

Getting lost with frequent changes... where is the latest?

Case 1 : VAT and Simplified VAT

- Budget Speech 2017 announced abolishment of SVAT, but the notice from IRD on 12 April 2017, suggested continuation of SVAT.
- However notice was not widely acknowledged to businesses when issued.
- Investors will never know or understand the processes without finding this notice in the website of IRD.

NOTICE TO THE TAXPAYERS
IMPLEMENTATION OF CHANGES PROPOSED IN BUDGET 2017

As announced by the Ministry of Customs, for taxpayers an informed that the existing provisions of the Internal Revenue Code (the Value Added Tax Act and the Stamp Duty Act, etc.) will continue to apply.



Director General,
Inland Revenue Department,
124A, 2017,
Rajivmawatha Road,
Colombo 10, Sri Lanka.

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Business Environment

Cases for S3 & M3: Public notice & tax reform and transparency

Legislate global good practices that already exist in SL.

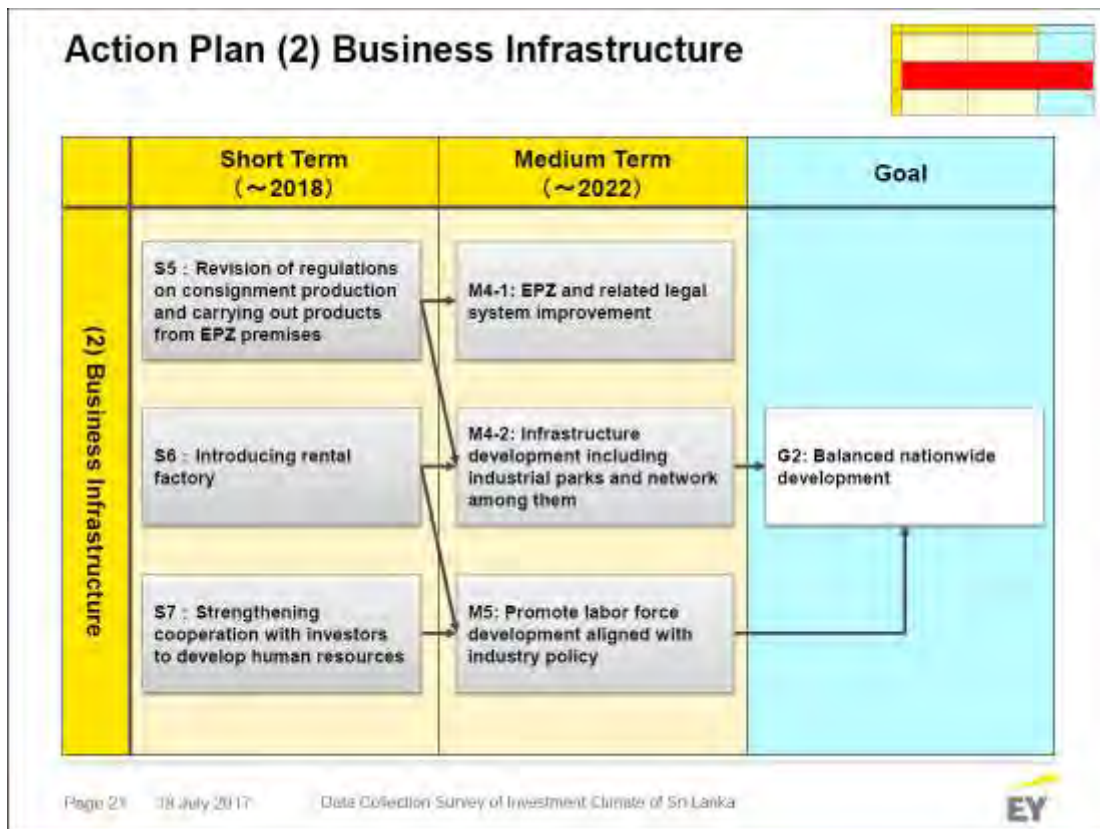
Case 2 : Advance ruling

- Advance ruling system is in practice by Sri Lanka customs. However it is not legislated now, and it is expected to be legislated in accordance with the WTO agreement.
- Advance ruling is listed in category C of the WTO agreement for Sri Lanka.
- Category B and C are expected to be legislated in 2018 by legislation of the New Customs Ordinance.

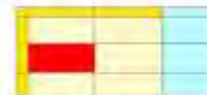


- It may not be necessary to legislate the whole articles of Category B and C at once.
- It may be preferable to specially select some articles of Category B and C of the WTO agreement that Sri Lanka customs already performs in practice or investors/traders strongly wish to introduce as soon as possible.
- Legislation of trade practices to harmonize global trade rules will improve transparency and predictability of trade processes.

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Business Infrastructure S5: Consignment Production (Sub-EPZ)



Formalize consignment production that already exists.



Consignment production

- Companies located within EPZ, contract with production facilities outside of EPZ.
- Production center in rural areas are active as a sub-EPZ.
- Already in action by some investors in EPZs.

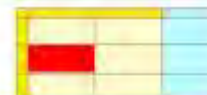
Merit for Investors

- Existing investor could expand their business overcoming land constraints in EPZs.

Merit for SOGL

- Support the need of existing investors to expand business with relatively easier than developing a new EPZ or large scale factory development.
- Create job opportunities for villages outside of EPZ.
- Labor forces previously employed at EPZ but had moved back to village can have opportunities.

Business Infrastructure S6: Rental Factory



As seen in SE Asia, rental factory maximizes land use.



Rental factory

- Rental factory provide "Plug & Play" environment with minimum refurbishment of facility.
- Rental factory can start a small scale, high-end niche production.
- Several practices already in SE Asian countries.

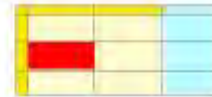
Merit for investors:

- Easy to start up businesses in Sri Lanka without significant investment for infrastructures.
- Smaller scales investments for high-end, high-value products can enter Sri Lanka.

Merit for GOSL:

- Utilize available industrial lands for production.
- Open windows to various size, industry investors to try Sri Lanka with least preparation by GOSL (existing facilities to be utilized).

Business Infrastructure S6: Rental Factory (Example in Vietnam)

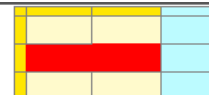


- Tang Long 2 Industrial Park in Hanoi, Vietnam
 - 36 rental factories are located in vicinity of Hanoi.
 - Rental Factories in Tang Long 2(#26), are mainly automotive components related companies

| | Rental Factory | Industrial Park |
|-----------------------------|-------------------|----------------------|
| Minimum Area | 500m ² | 10,000m ² |
| Minimum Period | 3 years | 40 years |
| Annual Rental fee (Ave) USD | 72/m ² | 42/m ² |



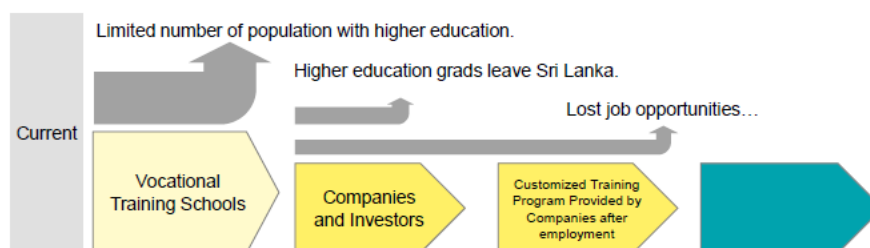
Business Infrastructure S7 & M5: Human Resources Development for Industry



Lack of skilled labor force discourages potential investors.

Current

- ▶ Limited number of young population are provided with higher education.
- ▶ Higher education graduates leave for foreign countries for better jobs.
- ▶ Some graduates end up with low-value added jobs.

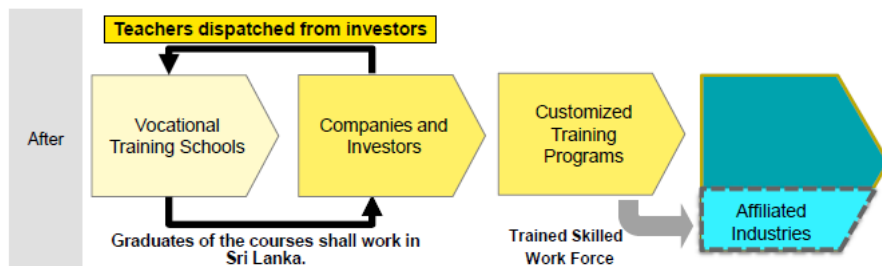


Business Infrastructure S7 & M5: Human Resources Development for Industry

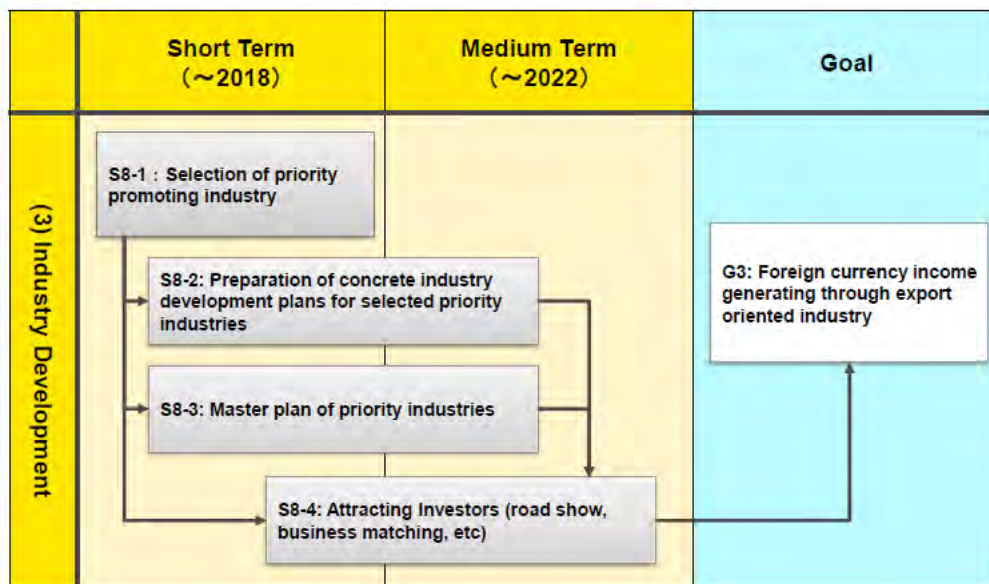
Private sector involvement can boost quality of training.

Proposal

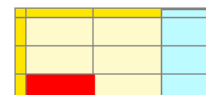
- ▶ The involvement of companies and investors will improve quality of education in vocational training and employability of graduates.
- ▶ The increase in trained skilled work force could lead to enhance investment from affiliated industry.



Action Plan (3) Industry Development



Industry Development S8: Priority Industry Targeting & Promotion



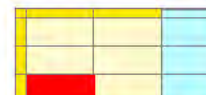
GOSL needs to narrow down long lists of priority industries.

| | | WB | BOI | EDB | CCC |
|---------------|-----------------------|----|-----|-----|-----|
| Manufacturing | Apparel/Textile | ★ | | | |
| | Food Manufacturing | ★ | | ★ | ★ |
| | High Value Rubber | ★ | | | |
| | Electronics | | | ★ | |
| | Automotive components | ★ | ★ | ★ | |
| | Pharmaceutical | ★ | ★ | | |
| | Medical Equipment | ★ | ★ | | |
| | Photovoltaic Panel | | ★ | | |
| | Metal Processing | | ★ | | |
| Service | IT | ★ | | | ★ |
| | Logistics | ★ | ★ | | ★ |
| | Tourism | ★ | ★ | | ★ |

Proposed Criterion

- ▶ Existence of successful investors in Sri Lanka
- ▶ High value-added industry with growth potential that fosters large supporting industries

Industry Development S8: Priority Industry Targeting & Promotion



Auto parts and Electronics are the top priority industries.

| | Sectors | Total | Market | Local Procurement | Infra & Logistics | HR | Comparative Advantage |
|---------------------------|-------------------------|-------|--------|-------------------|-------------------|----|-----------------------|
| Major Export Industry | Apparel, Textiles | ●● | ●● | ●● | ●● | ●● | ●● |
| | IT/BPM | ●● | ●● | — | ●● | ●● | ●● |
| | Logistics | ●● | ●● | — | ●● | ●● | ●● |
| | Tourism | ●● | ●● | — | ●● | ●● | ●● |
| Less Export Industry | Food Processing | ●● | ●● | ●● | ●● | ●● | ●● |
| | Rubber Products | ●● | ●● | ●● | ●● | ●● | ●● |
| Industry Under Evaluation | Auto Parts | ●● | ●● | ●● | ●● | ●● | ●● |
| | Electronics & Electrics | ●● | ●● | ●● | ●● | ●● | ●● |
| | Pharmaceutical | ●● | ●● | ●● | ●● | ●● | ●● |
| | Medical Equipment | ●● | ●● | ●● | ●● | ●● | ●● |
| | Solar panel | ●● | ●● | ●● | ●● | ●● | ●● |

- ▶ Regulations and FTA preferential lists should reflect needs from priority industries.

Action Plan -Points

| | Short Term (~2018) | Medium Term (~2022) |
|--------------------------------|---|------------------------|
| (1) Business Environment | <ul style="list-style-type: none"> ❑ Design non-tax incentives as post-investment & customized services ❑ Shift BOI's core function from tax exemption to entry promotion & reinvestment ❑ Clarify what minimum investment criteria stands for | |
| (2) Business Infrastructure | <ul style="list-style-type: none"> ❑ Enhance EPZ capacities <ul style="list-style-type: none"> ➢ Consignment production outside of EPZ ➢ Rental factory ❑ Involve private sector to boost skilled labor training | |
| (3) Industry Development | <ul style="list-style-type: none"> ❑ Prioritize industries with successful precedence and growth potential that foster large supporting industries ❑ Auto and Electronics are recommended | |